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Insider Reporting Obligations and Options Backdating

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Abstract

Insider reporting rules have historically been regarded primarily as a regulatory tool to detect or prevent the improper use of undisclosed information by insiders of reporting issuers. When new Canadian rules governing the reporting of securities trades by insiders of reporting issuers came into effect in April 2010, options backdating was also identified as a policy rationale for insider reporting requirements. For insider reporting requirements to perform an effective secondary role in combating improper options backdating, clear rules on the timing of reporting obligations and rigorous enforcement would be required. It is not clear that the administration and enforcement of current Canadian insider reporting rules, crafted with very different objectives in mind, provide an effective deterrent to improper options backdating. This paper reviews the current rules and the mechanisms for their enforcement, offers a comparison with insider reporting regimes in other selected jurisdictions, reveals weaknesses in the Canadian approach and provides recommendations to enhance the Canadian regime so that it may effectively deter or detect options backdating.

(I) Introduction

In April 2010, new rules governing the reporting of securities trades by insiders of reporting issuers came into effect in Canada. These new rules were embodied in National Instrument 55-104[1] and in contemporaneous harmonized changes to Ontario's *Securities Act*.[2] Under the new regime, the deadline for filing insider reports has been shortened, from ten calendar days to five calendar days[3] following a purchase or sale.[4] When a draft of NI 55-104

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[1] *Insider Reporting Requirements and Exemptions*, NI 55-104 (23 April 2010) [NI 55-104]. Certain provisions of NI 55-104, including the shortened period for filing of insider reports, was subject to a six-month transition period, and so came into effect as of November 1, 2010. See NI 55-104, s 11.2.
[2] *Securities Act*, R.S.O. 1990, c. S.5, s 107, as re-enacted by *Budget Measures Act, 2006 (No. 2)*, S.O. 2006, c. 33, Schedule Z.5, s 10.
[3] NI 55-104, *supra* n 1 at s 3.3, 2.2; *Securities Act*, R.S.O. 1990, c. S.5 [*Securities Act*], s 107(2).

was first published for comment, the Canadian Securities Administrators linked this proposed timing change, among other things, to the practice of improper stock options backdating:

> We are proposing to accelerate the deadline for filing insider reports from 10 calendar days to five calendar days after a trade because we think the market would benefit from more timely dissemination of information relating to insider transactions. *Accelerating the reporting deadline should also address concerns about improper activities involving stock options and similar equity-based instruments, including stock option backdating, option repricing, and the opportunistic timing of option grants. More timely disclosure of option grants and public scrutiny of such disclosure would generally limit opportunities for insiders to engage in improper dating practices.*[5]

Deterring options backdating is also mentioned as a policy rationale for insider reporting requirements in the companion national policy statement, 55-104 CP.[6]

The suggestion that insider reporting obligations might deter the practice of options backdating[7] is intriguing. Insider reporting rules have historically been regarded primarily as a

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[4] The time period within which to file an initial insider report, however, upon first becoming a reporting insider, is ten days. See NI 55-104 *supra* note 1, s 3.2. As a technical matter, a "trade" for purposes of Canadian securities laws refers only to a sale of securities. Insider reporting obligations, of course, apply in the case of both purchases and sales of securities. In this paper, the word "trade" will frequently be used in a non-technical way to refer to both purchases and sales, unless the context indicates use of the more precise statutory term.

[5] *CSA Notice and Request for Comment-Proposed National Instrument 55-104 Insider Reporting Requirements and Exemptions, Companion Policy 55-104CP Insider Reporting Requirements and Exemptions and Related Consequential Amendments* (2008) 31 OSCB 12117 at 12120 [emphasis added].

[6] *Insider Reporting Requirements and Exemptions*, C.P. 55-104CP, s 1.3(2), (23 April 2010) [55-104CP].

[7] Options backdating refers to the practice of issuing share purchase options to corporate executives or other insiders or employees dated as of some date prior to the date of actual issue. The earlier date is strategically chosen as a date on which the market price of the underlying share was lower than its current price, and the option is issued with an exercise (or strike) price equal to that earlier lower price. The effect of backdating is to

regulatory tool to detect or prevent the improper use of inside information by insiders of reporting issuers. For these requirements to perform an effective secondary role in combating improper options backdating, clear rules on the timing of reporting obligations and rigorous enforcement would be required. It is not clear that the administration and enforcement of current Canadian insider reporting rules, crafted with very different objectives in mind, provide an effective deterrent to improper options backdating. A review of the current rules and the mechanisms for their enforcement, together with a comparison with insider reporting regimes in other selected jurisdictions, reveals weaknesses in the Canadian approach and suggests ways in which the Canadian regime could be enhanced to deter or detect options backdating.

Part II of this article briefly reviews the origin and traditional rationale for Canadian insider reporting rules. Part III surveys the substantive requirements of the Canadian insider reporting regime. Part IV discusses apparent limitations in the enforcement of insider reporting requirements. Part V analyses the efficacy of insider reporting rules as a tool for deterring improper options backdating. Part VI offers concluding remarks and some tentative recommendations for reform.

(II) Origin and Rationale of Insider Reporting Rules

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disguise the fact that the option has not been issued "at the money" (that is, with an exercise price equal to the market price) but is, in fact, already "in the money". For a more detailed discussion of the issue of options backdating, see Ryan Compton, Daniel Sandler & Lindsay M. Tedds, "Options Backdating: A Canadian Perspective" (2009) 47 Can. Bus. L.J. 329. For a discussion of the specific securities law issues raised by options backdating in the United States, where the practice was first identified, see M.P. Narayanan, Cindy A. Schipani & H. Nejat Seyhun, "The Economic Impact of Backdating of Executive Stock Options" (2007) 105 Mich. L.J. at 1597; Matthew S. Chambers, "Last Ditch Options: An Assessment of Independent Director Liability and a Proposal For Congressional Action in Light of the Employee Stock Option Back-Dating Scandal" (2008) 42 Ga. L. Rev. 569. See also the sources referred to in note 34, *infra*.

Certain insiders of Canadian reporting issuers are required to file public reports when they buy or sell securities of that reporting issuer. That requirement was originally contained in the securities statutes of most Canadian provinces and territories. On April 23, 2010, many of the various provincial and territorial statutory rules were replaced by National Instrument 55-104. In Ontario, the primary insider reporting obligations continue to be those set out in section107 of the Ontario *Securities Act* rather than National Instrument 55-104, although the substance of the Ontario provisions has been harmonized with the requirements of National Instrument 55-104.[8]

The insider reporting filing requirement was introduced into Ontario securities legislation in 1966[9] following a 1965 recommendation of the Kimber Committee.[10] The primary concern of the Kimber Committee was the improper use of confidential information by insiders to make trading profits.[11] The insider reporting regime was part of a "two fold"[12] remedy proposed by the Kimber Committee to combat such improper use of inside information.[13] Insider reporting, in the Committee's view, would be an effective instrument because, "The insider who knows that his trading will become public knowledge will be less likely to engage in improper trading."[14]

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[8] NI 55-104, *supra* n 1, s 2.1.
[9] *Securities Act,* S.O. 1996, c. 142. Canadian corporate statutes had previously included trade reporting requirements applicable only to corporate directors. See e.g. *Corporations Act,* R.S.O. 1960, c. 71, s 71; *Companies Act*, R.S.C. 1952, c. 53, s 98.
[10] Ontario, The Report of the Attorney General's Committee on Securities Legislation in Ontario (Toronto: Queen's Printer, March 1965)[Kimber Report].
[11] *Ibid.,* s 2.02.
[12] *Ibid.,* s 2.04.
[13] The second part of the regime was the specific legislative prohibition against the use by insiders of confidential information.
[14] Kimber Report, *supra* note 10, s 2.04.

In 1979, as part of the extensive review of Canadian securities legislation undertaken in connection with the publication of *Proposals for a Securities Market Law for Canada*,[15] a background paper on insider trading written by Marvin Yontef suggested that the insider reporting requirements performed "several independent functions." These functions included providing potential evidence in legal proceedings based on improper insider trading and functioning as a public revelation of the insider's assessment or evaluation of the reporting issuer's securities.[16]

Although early insider reporting requirements in the Ontario *Securities Act* extended to options, the statute limited reporting to "transferable" options.[17] The practical effect of this, as Yontef pointed out, was that acquisition of a stock option pursuant to a stock option plan would normally not be a reportable event since "until the option is exercised, the option was not 'transferable'."[18]

Not surprisingly, then, the original drafters of the insider reporting provisions in provincial securities legislation did not anticipate the problem of options backdating, and the insider reporting rules were not intended to, and did not, operate so as to deter backdating.

The focus of insider reporting rules on deterring improper insider trading and more

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[15] For a comprehensive explanation of the background of this ambitious but ultimately ill-fated early proposal for a national securities regulator for Canada, see Philip Anisman, "The Proposals for a Securities Market Law for Canada: Purpose and Process" (1981) 19 Osgoode Hall L.J. 329.
[16] Marvin Yontef, "Insider Trading" in *Proposals for a Securities Market Law for Canada,* Vol. 3 (Ottawa: Minister of Supply and Services Canada, 1979) 625 [Yontef] at 631.
[17] See *Securities Act*, R.S.O. 1970, c. 426, s 109(2)(b): "the acquisition or disposition of an insider of a put, call or other transferable option with respect to a capital security shall be deemed a change in the beneficial ownership of the capital security to which such transferable option relates."
[18] Yontef, *supra* n 16 at 641. Yontef also notes that federal corporate law at the time would require insiders of such corporations to file an insider report at the time of the grant of the stock option itself.

broadly informing the market is not unique to Canada. Historically, U.K. insider reporting rules applicable to officers and directors were based on similar concerns about the improper use of confidential information. However, insider reporting obligations imposed on major shareholders were seen as necessary to prevent secret acquisitions of a corporation's stock as part of a corporate takeover strategy.[19] Similarly, insider reporting rules introduced into U.S. federal securities legislation in 1934[20] were hailed at the time as a tool that would assist investors in determining whether or not to buy or sell securities of particular issuers and as "the most potent weapon against the abuse of inside information."[21] Australian insider reporting rules are also aimed at preventing unlawful insider trading and improving transparency for investors. As Jennifer O'Donnell, Executive Director of Compliance at the Australian Securities and Investments Commission, has explained:

> The obligation to notify directors' interests is a central aspect of corporations law, and together with the insider trading prohibitions and the continuous disclosure requirements, helps to maintain an informed market.[22]

Eric Mayne, Australia's Group Executive Market Supervisor, echoed those goals, stating, "Transparency of directors' interests is all about sustaining confidence in our financial

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[19] See Paul L. Davies, *Gower and Davies' Principles of Modern Company Law,* 7th ed (London: Sweet & Maxwell, 2003) at 593. Under Canadian securities law, this goal is more often associated with the so-called "early warning requirements". See *The Early Warning System and Related Take-Over Bid and Insider Reporting Issues*, NI 62-103, (23 April 2010); *Securities Act*, *supra* n 3, s 102.1.

[20] *Securities Exchange Act of 1934*, Pub L No 73-291, § 16(a), 48 Stat 881 (1934) (codified as amended at 15 USC § 78a-78kk (1994)) [*Exchange Act*].

[21] H. R. No. 1383, 73rd Cong., 2d Sess 13 (1934), quoted in Janet Gamer Feldman and Richard L. Teberg, "Beneficial Ownership Under Section 16 of the Securities Exchange Act of 1934" 17 Case W. Res. L. Rev. (1965-1966) 1054 at 1062.

[22] Australian Securities and Investments Commission, Media Release, 05-324, "ASIC and the ASX urge directors to notify market operators of shareholdings" (19 October 2005) online: Australia Securities and Investment Commission <http://www.asic.gov.au/asic/asic.nsf/byheadline/05-324+ASIC+and+the+ASX+urge+directors+to+notify+market+operators+of+shareholdings>.

market and strengthening the integrity of Australian corporations."[23]

Recent regulatory decisions confirm the view that the principal aims of the insider reporting obligations are to deter improper insider trading and to provide the market information concerning insiders' apparent "views concerning the prospects of the issuer."[24] Further, even as recently as 2002, commentary accompanying reforms to U.S. insider reporting rules still identified market efficiency as the aim of such changes, not the deterring or detection of improper options backdating.[25]

It is hardly surprising that insider reporting rules were not originally crafted with the goal of deterring or detecting options backdating. The use of options as a key component of compensation was probably not widespread at least until the 1980s,[26] and the issue of options backdating had not, in any event, been identified as a potentially serious concern until the publication of a series of articles by Erik Lie, beginning in 2005.[27] Although, in at

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[23] *Ibid.*

[24] *Rowan (Re)* (2008), 31 OSCB 6515 at para 78; *Hinke (Re)* (2006), 29 OSCB 4171 [*Hinke*] at paras 16-17.

[25] "Form 8-K Disclosure of Certain Management Transactions," Securities Act Release No. 8090, Exchange Act Release No. 45742 (12 April, 2002) [67 FR 19914, at 19920], online: Securities Exchange Commission <http://www.sec.gov/rules/proposed/33-8090.htm>. "The two business day accelerated deadline is intended to provide investors with rapid disclosure of the most significant events, while allowing the company sufficient time to compile the required information."

[26] In 1994, the US enacted s. 162(m) of the *Internal Revenue Code*, 26 U.S.C. §162(m), which limited the deduction of non-performance-based compensation to $1 million for the CEO and next four highest paid executives of a corporation. Stock options are considered performance-based (and therefore not subject to the restriction) provided certain conditions are met. In particular, the options must be granted not-in-the-money. Some have suggested that it was the introduction of this provision that made the practice of granting options (at- or below-the-money) to insiders widespread. See, *e.g.*, Gennaro Bernile & Gregg A. Jarell, "The Impact of the Options Backdating Scandal on Shareholders" (2009) 47:1 Journal of Accounting & Economics 2 at 3. Skeptics suggest that the "explosion in grants of stock options was already underway in the 1980s" but admit the amended tax rule "constituted an implicit government 'blessing' of stock options as appropriate performance-based pay" that may have further fueled the trend. See Brian Hall and Kevin Murphy, "The Trouble with Stock Options" (2003) 17:3 Journal of Economic Perspectives 49 at 62.

[27] See Erik Lie, "On the Timing of CEO Stock Option Awards" (2005) 51 Management Science 802. The pattern of abnormally high stock returns following the grant of executive options had been documented many years earlier. See e.g. David Yermack, "Good Timing: CEO Stock Option Awards and Company News Announcements" (1997), 52 Journal of Finance 449. However, this earlier work suggested that the abnormal

least two earlier Securities and Exchange Commission ("SEC") enforcement actions, in 2003 and 2004, the SEC targeted practices that would today be labeled options backdating.[28]

(III) Options Backdating and the Mechanics of the Canadian Insider Reporting Rules

Current Canadian insider reporting rules require reporting insiders[29] of a reporting

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price patterns implied that insiders' ability to time option purchases reflected their exploitation of undisclosed inside information which subsequently led to price increases. It was Mr. Lie who drew the link between these abnormal returns and the possibility of backdating.

[28] See Securities and Exchange Commission, Litigation Release No. 18205, *Securities and Exchange Commission v. Peregrine Systems, Inc.*, Civil Action No. 03 CV 1276 K (LAB) (S.D. Cal.) (30 June 2003) online: <http://www.sec.gov/litigation/litreleases/lr18205.htm>; Securities and Exchange Commission, Litigation Release, No. 18734, *SEC v. Symbol Technologies, Inc., Tomo Razmilovic, Kenneth Jaeggi, Leonard Goldner, Brian Burke, Michael DeGennaro, Frank Borghese, Christopher DeSantis, James Heuschneider, Gregory Mortenson, James Dean and Robert Donlon*, CV 04 2276 (LDW)(WDW) (EDNY) [(3 June 2004)] online: <http://www.sec.gov/litigation/litreleases/lr18734.htm>.

[29] The term "reporting insider" is defined in NI 55-104, *supra* n 1 s 1.1(1) as meaning:
an insider of a reporting issuer if the insider is
(a) the CEO, CFO or COO of the reporting issuer, of a significant shareholder of the reporting issuer or of a major subsidiary of the reporting issuer;
(b) a director of the reporting issuer, of a significant shareholder of the reporting issuer or of a major subsidiary of the reporting issuer;
(c) a person or company responsible for a principal business unit, division or function of the reporting issuer;
(d) a significant shareholder of the reporting issuer;
(e) a significant shareholder based on post-conversion beneficial ownership of the reporting issuer's securities and the CEO, CFO, COO and every director of the significant shareholder based on post-conversion beneficial ownership;
(f) a management company that provides significant management or administrative services to the reporting issuer or a major subsidiary of the reporting issuer, every director of the management company, every CEO, CFO and COO of the management company, and every significant shareholder of the management company;
(g) an individual performing functions similar to the functions performed by any of the insiders described in paragraphs (a) to (f);
(h) the reporting issuer itself, if it has purchased, redeemed or otherwise acquired a security of its own issue, for so long as it continues to hold that security; or
(i) any other insider that

> (i) in the ordinary course receives or has access to information as to material facts or material changes concerning the reporting issuer before the material facts or material changes are generally disclosed; and
> (ii) directly or indirectly exercises, or has the ability to exercise, significant power or influence over the business, operations, capital or development of the reporting issuer;

Although the insider reporting obligations set out in National Instrument 55-104 do not apply in Ontario, this definition of reporting insider also governs the insider reporting obligations in s 107 of the Ontario *Securities Act*. See National Instrument 55-104, s 9.2. For purposes of this paper, our primary focus is on senior officers and directors of a reporting issuer.

issuer to file an insider report in prescribed form[30] within five days of the sale or purchase of a security of the reporting issuer.[31] Reports are filed electronically on the System for Electronic Disclosure by Insiders ("SEDI") system.[32] Failure to file these reports as required constitutes an offence under securities law.[33] Rigorous compliance with these rules would make opportunistic options backdating virtually impossible. A grant of options to an officer or director would need to be disclosed within five days, too narrow a window—absent unusual market jumps—within which to identify a date on which the reporting issuer's stock was trading at such a materially lower price that backdating would be profitable to the insider. This five day requirement is, however, less stringent than the current U.S. two-day requirement. Studies have shown that the two-day rule has meant "the ability to backdate option grants to coincide with days with low stock prices is greatly diminished."[34] The Canadian Securities Administrators ("CSA") chose not to adopt the US two-day rule when promulgating National Instrument 55-104, arguing that such a rule was unnecessary because, "given the significant media attention and recent enforcement actions in the US and Canada

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30 See *System for Electronic Disclosure by Insiders (SEDI)*, NI 55-102, Form 55-102F2, (20 June 2008) [NI 55-102].
31 NI 55-104, *supra* n 1, s 3.3; *Securities Act*, *supra* n 3, s 107(2).
32 NI 55-102, *supra* n 30.
33 *Securities Act*, *supra* n 3, s 122(1)(c).
34 Randall A. Heron & Erik Lie, "Does Backdating Explain the Stock Price Pattern around Executive Stock Option Grants?" (2007) 83 J. Fin. Econ. 271 at 273 [Heron & Lie, "Does Backdating Explain"]; Randall A. Heron & Erik Lie, "What Fraction of Stock Option Grants to Top Executives Have Been Backdated or Manipulated?" (2009) 55 Management Science 513 [Heron & Lie, "What Fraction of Option Grants"]. See also Daniel Collins, Guojin Gong & Haidan Li, "The Effect of the Sarbanes-Oxley Act on the Timing Manipulation of CEO Stock Option Awards" (2005) (concluding that the changes introduced by the Sarbanes-Oxley Act reduced the apparent use of backdating) online: SSRN < http://ssrn.com/abstract=850564>; David I. Walker, "Unpacking Backdating: Economic Analysis and Observations on the Stock Option Scandal" (2007) 87 B.U.L. Rev. 561 at 617 (suggesting that the new 2002 rule change to two days"all but prevents backdating") M.P. Narayanan & H. Nejat Seyhun, "Effect of Sarbanes-Oxley Act on the Influencing of Executive Compensation" (2005), online: SSRN http://ssrn.com/abstract=852964 [Narayanan & Seyhun, "Effect of SOX"]; But *cf.*, Jesse Fried, "Option Backdating and its Implications" (2008) 65 Wash. & Lee L. Rev. 853, suggesting that option backdating is still prevalent after SOX, and suggesting that the 2002 changes did not go far enough; Lucian Bebchuk & Jesse M. Fried, "Paying for Long Term Performance"(2010) 158 U. Pa. L.R. 1915 at 1937 (although suggesting that heightened media and regulatory scrutiny should reduce or eliminate backdating, the authors nevertheless conclude that the amendments do not go far enough). See also John Shipman, "The Future of Backdating Equity Options in the Wake of SEC Executive Compensation Disclosure Rules" (2007) 85 N.C.L. Rev. 1194, in which the author discusses subsequent SEC reforms in 2006 that, in his view, tacitly legitimates backdating by "only" increasing disclosure.

issuers and insiders are aware of their obligations and will act in compliance with their obligations."[35] It appears, however, that the technical application of Canadian insider reporting rules when applied to stock options, as well as various enforcement issues, may vitiate the effectiveness of these rules in preventing options backdating.

A key shortcoming of the current Canadian reporting regime is that the obligation to file insider reports rests solely on the individual receiving a grant of options; yet in many cases it is possible that the insider may not immediately be aware that options have been granted to him or her. Where there is a lag between the actual grant date (the "Grant Date"), and the date on which the insider is notified of the options granted to him or her (the "Notification Date"), robust application of the insider reporting rules becomes problematic. This problem does not arise from any deficiency in the insider reporting requirements themselves, but rather from the practical problem that securities regulators may be legitimately reluctant to attempt to discipline insiders for failure to file reports in a timely way when that failure is owing entirely to the issuer's actions, and not to any fault of the insider.

To understand how internal corporate practice with respect to notifying an option grantee could lead to a technical, but innocent, breach by an insider of the reporting rules, it is useful to review those rules in some detail. The reporting obligation is triggered by a change in the reporting insider's

[35] *CSA Notice - National Instrument 55-104, Insider Reporting Requirements and Exemptions and Related Companion Policy 55-104CP and Repeal of Related Predecessor Instruments*, (2010) 33 OSCB 645 [Notice of NI 55-104] at 662.

(a) beneficial ownership of, or control or direction over, whether direct or indirect, securities of the reporting issuer, or

(b) interest in, or right or obligation associated with, a related financial instrument involving a security of the reporting issuer.[36]

In the case of an option, the change in an insider's beneficial ownership would occur on the Grant Date. As a practical matter, however, the insider would simply not be in a position to file an insider report until the Notification Date.

The Canadian Securities Administrators explicitly acknowledged this problem in Companion Policy 55-104CP, including precatory language indicating that "[t]he issuer should take all reasonable steps to notify reporting insiders of their grants in a timely manner to allow reporting insiders to comply with their reporting obligations."[37] However, this language is contained only in a policy statement, not in the text of the National Instrument itself, and is therefore not of a mandatory, legislative nature.[38] Moreover, it is our understanding that, in recognition of this practical limitation, Canadian securities commissions may at times have been prepared to allow reporting insiders to treat the Notification Date as the date of the "change of beneficial ownership" for purposes of the insider reporting requirement.

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[36] NI 55-104, *supra* n 1, s 3.3; *Securities Act*, *supra* n 3, s 107(2).
[37] 55-104CP, *supra* n 6, s 6.2(4).
[38] *Securities Act*, *supra* n 3, s. 143.8(1)(d).

National Instrument 55-104 gives reporting issuers the option (but not the obligation) to file stock-based compensation reports (an "issuer grant report") on behalf of directors and officers, in which case the director or officer is required only to file an annual report.[39] Under section 6.2, a director or officer is not required to file an insider report if:

(a) the reporting issuer has previously disclosed the existence and material terms of the compensation arrangement in an information circular or other public document filed on System for Electronic Document Analysis and Retrieval ("SEDAR");

(b) in the case of an acquisition of securities, the reporting issuer has previously filed in respect of the acquisition an issuer grant report on SEDI in accordance with section 6.3; and

(c) the director or officer complies with the alternative reporting requirement in section 6.4.

Section 6.3 provides that the issuer grant report include the following information:

(a) the date the option or other security was issued or granted;

(b) the number of options or other securities issued or granted to each director or officer;

(c) the price at which the option or other security was issued or granted and the exercise price;

[39] NI 55-104, *supra* n 1. ss 6.1-6.4.

(d) the number and type of securities issuable on the exercise of the option or other security; and

(e) any other material terms that have not been previously disclosed or filed in a public filing on SEDAR.

The CSA rejected a proposal (in a submission responding to draft National Instrument 55-104) that the issuer grant reports should be obligatory, commenting:

> Currently, timely disclosure of grants (or repricings) of options and similar instruments is achieved through the insider reporting system. There does not currently exist a timely disclosure obligation on issuers to report grants of options or similar instruments, other than through certain exchange requirements, unless such a grant is considered a material change. So long as the reporting obligation rests with the insider recipient, it is necessary to balance the interest in investors in timely disclosure about grants or repricings with the interest in not imposing an undue burden on insiders in being able to comply with their obligations.[40]

The Canadian approach of placing the burden of filing solely on the insider may be contrasted with the UK rules where the corporation bears responsibility for public filing of trading reports. The UK rules do not use the phrase "insider," but rather impose reporting requirements on trades by large shareholders and "persons discharging managerial responsibilities" ("PDMR"). The UK Financial Services Authority ("FSA") requires that

[40] Notice of NI 55-104, *supra* n 35 at 671.

shareholders holding 3% of the company's voting rights or more must notify the corporation once they acquire 3%, cease to hold 3%, and whenever they engage in any transaction that changes their holding in the company by at least 1%.[41] That notification must come "as soon as possible," and no later than two trading days after the person learns of the notification, ought to have learned of the notification, or is informed of the change in percentage of voting rights held.[42] The corporation then has a duty to disclose these changes to the public by the end of the trading day following receipt of the notification.[43]

In the case of PDMRs, when a transaction occurs, a PDMR must notify the corporation within 4 business days.[44] The corporation must then inform an FSA-approved Regulated Information Service ("RIS") of the transaction "as soon as possible" and no later than the end of the business day following receipt of the notification of the transaction.[45] Where the corporation itself is aware of the transaction at the outset—as should be the case with the grant of stock options—the corporation would be obliged to inform the RIS by the end of the following business day.

Putting the ultimate onus to report publicly on the corporation is one reason that

[41] United Kingdom Financial Services Authority, Financial Services Handbook: Disclosure and Transparency Rules DTR 5.1.2, online: Financial Services Authority <http://fsahandbook.info/FSA/html/handbook/DTR/5/1>.
[42] United Kingdom Financial Services Authority, Financial Services Handbook: Disclosure and Transparency Rules DTR 5.8.3, online: Financial Services Authority <http://fsahandbook.info/FSA/html/handbook/DTR/5/8>.
[43] United Kingdom Financial Services Authority, Financial Services Handbook: Disclosure and Transparency Rules DTR 5.8.12, online: Financial Services Authority <http://fsahandbook.info/FSA/html/handbook/DTR/5/8>.
[44] United Kingdom Financial Services Authority, Financial Services Handbook: Disclosure and Transparency Rules DTR 3.1.2, online: Financial Services Authority <http://fsahandbook.info/FSA/html/handbook/DTR/3/1>.
[45] United Kingdom Financial Services Authority, Financial Services Handbook: Disclosure and Transparency Rules DTR 3.1.4, online: Financial Services Authority <http://fsahandbook.info/FSA/html/handbook/DTR/3/1>.

some UK lawyers believe their market has not experienced the kind of outbreak of options backdating that has occurred in the US or Canada:

> It is simply not an option for publicly listed companies to pretend that an option was granted days or even weeks ago. Publicly traded companies must disclose any grants of options to directors as soon as possible. In fully listed companies that includes people discharging managerial responsibility. This disclosure must come no later than the end of the following trading day, effectively preventing any back-dating of option grants.[46]

Australia, too, has rules that put the onus on corporations to file insider reports. Australian Securities Exchange ("ASX") Listing Rules require listed corporations to notify the ASX of changes in a director's interest within five days of the change.[47] Australia's rules, however, apply only to directors, not officers. Nevertheless, the fact that both Australian and UK rules require corporations to disclose publicly the trading activity of insiders indicates that such a requirement is neither unusual nor unduly onerous.

(IV) <u>Enforcement of Insider Reporting Rules</u>

Insider reporting requirements could operate as an effective check on options backdating only if there were vigorous enforcement of those rules. Enforcement of

[46] Rory Cray, "Why the Options Backdating Scandal Won't Hit the UK" (24 January 2008), online: Out-Law.com (Pinsent Masons) <http://www.out-law.com/page-8825>.
[47] Australian Securities Exchange Listing Rules: Chapter 3 Continuous Disclosure, r 3.19A,online: Australian Securities Exchange <http://www.asx.net.au/ListingRules/chapters/Chapter3.pdf>.

Canadian securities laws generally has frequently been criticized[48] and, at least in comparison with especially robust U.S. practices, is perceived to be lax.[49] Because the insider reporting rules were originally designed as a means of preventing the improper use by insiders of confidential information, it is not surprising that it is unlawful insider trading that is the mischief about which regulators are principally concerned.[50] The insider reporting obligations have come to be regarded as an administrative matter except in those rare cases in which there is also evidence of improper insider trading. Given scarce regulatory resources, enforcement of administrative requirements would not be expected to be given high priority.

In any event, the penalties for late filing of insider reports are not onerous. Six Canadian provinces have no specifically prescribed late fees for delinquent filers of insider

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[48] See, *e.g.*, the recent Ontario government all-party committee report on the Ontario Securities Commission, Ontario, Legislative Assembly, Standing Committee on Government Agencies, *Report on Agencies, Boards and Commissions, Ontario Securities Commission* (March 2010), ("The Chair of the Ontario Securities Commission acknowledged that securities law enforcement is the aspect of his agency's mandate that receives the most criticism…Weak enforcement, it is said, has fostered a perception that Ontario (and Canada) is soft on white collar crime, and has tarnished our international reputation.") at 12, online: Legislative Assembly of Ontario <http://www.ontla.on.ca/committee-proceedings/committee-reports/files_pdf/OSC%20Report%20English.pdf>.

[49] See, *e.g.*, Wise Persons' Committee to Review the Structure of Securities Regulation in Canada, *It's Time* (Ottawa: Department of Finance, 2003) at 7: "There is a widely held view that enforcement in Canada is lax in comparison with the United States and other countries." See also Hon. Peter deC Cory and Marilyn L. Pilkington, "Critical Issues in Enforcement", Research Study prepared for the Task Force to Modernize Securities Legislation in Canada, *Canada Steps Up* (2006), Vol. 6, 165 at 191-192. As well, William J. McNally & Brian F. Smith, "The Effect of Transparency on Insider Trading Disclosure" (2010) 36 Can. Pub. Pol'y 345 [McNally & Smith], investigate Canadian insider trading reporting for equity trades of TSX-listed firms and find that reporting errors have fallen from around 40% of insider reports in 1988 to 10% in 2006, while the average time from insider trade to disclosure dropped from around 50 to 11 days. These are tied to the move to a 10 day reporting window in 1999 and the establishment of SEDI in 2003. However as the authors point out, the disclosure lag of 11 days on average still represents disclosure outside the maximum allowable 10 day window.

[50] Unlawful insider trading is prohibited by provincial securities laws. See *Securities Act*, R.S.A. 2000, c. S-4, s 147(2); *Securities Act*, R.S.B.C. 1996, c. 418, s 155(1); *The Securities Act*, R.S.M. 1988, c. S50, s 112(1); *Securities Act*, S.N.B. 2004, c. S-5.5, s 147(2); *Securities Act*, R.S.N. 1990, c. S-13, s 77(1); *Securities Act*, R.S.N.S. 1989, c. 418, s 82(1); *Securities Act*, *supra* n 3, s 76; *Securities Act*, R.S.P.E.I. 1988, c. S-3.1, s 155; *Securities Act*, R.S.Q. 1990, c. V-1.1, ss 187 and 189; *The Securities Act, 1988*, R.S.S. 1988-1989, c. S-42.2, s 85; *Securities Act*, S.N.W.T. 2008, c. 10, s 155; *Securities Act*, S.Nu. 2008, c. 12, s 155; *Securities Act*, R.S.Y. 2007, c. 16, s 155); by federal corporate law (*Canada Business Corporations Act*, R.S.C. 1985, c. C-44, s 131(4)); and by the *Criminal Code,* R.S.C. 1985, c. C-46, s 382.1).

reports. Penalties in the remaining four—British Columbia, Manitoba, Ontario and Quebec—are relatively modest. In British Columbia,[51] Manitoba,[52] and Ontario,[53] a late filer may be fined $50 per day, up to a maximum, in Manitoba and Ontario, of $1,000 per year. In Quebec, the fine is $100 per business day, to a maximum of $5000.[54]

The extent to which these penalties deter late filing is uncertain. In 2007, the Ontario Securities Commission ("OSC") reported that it had collected some $520,000 in fines for late insider reports,[55] an amount suggesting a considerable number of delinquent filers. However, in Quebec, following the introduction of a $100 per day late filing fee in 2006, the number of late-filed insider reports fell by 61% from the previous year.[56] Indeed, one comment received on the CSA's original NI 55-104 proposal asserted that the late filing system in Ontario "is rigorously enforced"[57] and cynically suggested that tightening the deadlines for filing appeared to be aimed at increasing securities commission revenues.[58]

Although enforcement actions have been taken against late filers in particularly egregious cases, there are few reported cases of enforcement actions brought against late filers except in conjunction with other more serious breaches of securities laws.

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51 B.C. Reg. 196/97, s 22, item 19(b).
52 Man. Reg. 491/88R, Schedule A, s 1(2)(ee).
53 *Fees*, O.S.C. Rule 13-502, (2 April 2010), s 4.3(3).
54 OC 660-83, (1983) G.O.Q. 2, 1269, s 271.14.
55 Ontario Securities Commission, *Annual Report 2007*, (Toronto: O.S.C., 2007), online: Ontario Securities Commission <http://www.osc.gov.on.ca/documents/en/About/rpt_2007-osc-en.pdf> at 32.
56 Autorité des marchés financiers, *Annual Report 2007-2008*, (Québec City: A.M.F., 2008), online: Autorité des marchés financiers <http://www.lautorite.qc.ca/userfiles/File/Publications/autorite/rapports-annuels/AMF_Rapport_annuel_2007-2008_ang.pdf> at 26.
57 Notice of NI 55-104, *supra* n 35 at 659.
58 *Ibid.*

For example, in 2006, Thomas Hinke, a former insider of Thermal Energy International Inc. ("Thermal Energy"), was sanctioned by the OSC for failure to report 32 trades involving securities of Thermal Energy, in breach of section 107(2) of the Ontario *Securities Act*, as well as a 2002 agreement he had signed with the OSC following earlier insider reporting violations.[59] Hinke was, among other things, banned from trading stocks in Thermal Energy for six months, from trading stocks in any other firms in which he owned more than a 5% interest for one year, and was ordered to pay an administrative penalty of $32,000 as well as investigation costs of $5,000.

Canadian securities laws also have rules for dealing with misleading reports generally.[60] In the context of insider reports, these rules are usually enforced where a breach of the rules is part of a larger insider-trading scheme where deception is discovered. For example, in 1996 the British Columbia Securities Commission sanctioned the chief financial officer of a reporting issuer, Beauchamps Exploration Inc., who had failed to file an insider trading report in the context of a proceeding involving a larger insider-trading scheme involving securities of the company.[61]

Accordingly, although late insider reporting is sometimes vigorously pursued and rigorously enforced, enforcement has historically occurred under circumstances that would likely have little deterrent effect on options backdating. Most insider reporting enforcement cases involve late fees and fines for individuals who fail to report insider trades for an extended period of time (often several years) or as part of a larger insider trading scheme.

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[59] *Hinke, supra* n 24.
[60] See e.g. *Securities Act*, *supra* n 3, s 122(1)(a).
[61] *Slightham (Re)* (29 July 1996), COR#96/151, online: British Columbia Securities Commission <http://www.bcsc.bc.ca>.

Regulators may well consider it a dubious use of scarce time and resources to meticulously investigate and prosecute an insider with respect to a trivial number of late reporting infractions.

The penalties for late or non-filing of insider trading reports in other jurisdictions also appear, at least in practice, to vary with the egregiousness of the insider's conduct. In the UK, the requirement to file insider reports is contained in the Disclosure and Transparency Rules appended to the FSA's Listing Rules.[62] The obligation to disclose is really an obligation owed to the company, not to the regulator. The company's obligation is then to notify an RIS by the end of the business day following receipt of the insider's report. The FSA has the authority to impose "a penalty of such amount as it considers appropriate"[63] on the company for failure to comply with this disclosure requirement. The statute also provides that,

> If, in such a case, the competent authority considers that a person who was at the material time a director of the issuer or applicant was knowingly concerned in the contravention, it may impose on him a penalty of such amount as it considers appropriate.[64]

In the US, there are no "standard" penalties for late reporting but an insider can be fined $100,000 under certain circumstances for late filing or failing to file under Section 16

[62] United Kingdom Financial Services Authority, Financial Services Handbook: Disclosure and Transparency Rules DTR 3.1, online: Financial Services Authority <http://fsahandbook.info/FSA/html/handbook/DTR/3/1>.
[63] *Financial Services and Markets Act* (UK), 2000, c 8, s 91(1).
[64] *Financial Services and Markets Act* (UK), 2000, c 8, s 91(2).

of the Exchange Act.[65] Such a penalty would apply "if the violation involved fraud, deceit, manipulation, or deliberate or reckless disregard of a regulator requirement and resulted in substantial losses or created a risk of substantial loss."[66] The SEC has imposed penalties for late filing, usually in circumstances involving multiple infractions or egregious delays. In 1993, the SEC imposed a cease and desist order as well as a penalty of $75,000 on an insider who was a repeat late filer, having filed 221 late reports over a 13-year period.[67] In 1996, the SEC fined a chief executive officer $50,000 for failing to file twelve reports, noting that if the reports had been properly filed, some would have revealed opposite-way transactions.[68] That same year, the SEC also imposed a cease and desist order against Robert D. Carl III for filing more than 40 reports as much as 10 years late. In addition to a disgorgement of $145,000, he was also penalized $10,000.[69]

(V) <u>Insider Reporting Rules as a Tool for Detecting Options Backdating</u>

In the original CSA notice proposing NI 55-104, the CSA also proposed an ancillary amendment to Form 51-102F5, the information circular form. That amendment would have required reporting issuers to include disclosure of any late filing fees relating to the late filing

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[65] *Remedies Act,* Pub. L. No 101-429, 104 Stat, 931 (1990).
[66] Stanton P. Eigenbrodt, ed, *A Practical Guide to Section 16: Reporting and Compliance*, 4th ed (USA: Aspen Publishers, 2004) at 5.01, n 10.
[67] Securities and Exchange Commission, Litigation Release No. 13827, *Securities and Exch. Comm'n v. Engle*, (7 October 1993).
[68] Securities and Exchange Commission, Litigation Release No. 15190, *SEC v. Parris H. Holmes Jr.*, (D.D.C. 1996).
[69] Securities and Exchange Commission, Release No. 34-36678, *In the Matter of Robert D. Carl III*, (4 January 1996).

of insider reports in the previous year.[70] The CSA subsequently withdrew that proposal, but indicated that it "may reintroduce a modified version of this proposal in the future."[71] Even in the absence of an explicit requirement to disclose late filing fees, however, it is apparent that insider reports could be used by regulators in conjunction with other publicly-filed documents to detect possible options backdating if regulators were convinced that this was a worthwhile way to allocate resources. Options grants reported in an issuer's annual management proxy circulars could be cross-checked against insider trading reports to reveal discrepancies and to flag potential abuses. Whether or to what extent cross-checks of this sort are undertaken by Canadian securities regulators is unknown. Not surprisingly, regulators are reticent about publicly disclosing their methods of monitoring compliance with securities laws.

There is evidence that Canadian securities commissions have undertaken efforts to monitor compliance. In 2009, for example, the British Columbia Securities Commission launched an initiative comparing compliance by insiders with their reporting obligations. They found "a relatively high degree of compliance in reporting."[72] There are also indications that securities commissions may cross-reference insider reports with other financial documents after an enforcement investigation commences. For example, in *Workum and Hennig (Re),*[73] Alberta Securities Commission staff argued that certain insider defendants who had failed to report impugned trades made through specific accounts were clearly aware of

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[70] *Notice and Request for Comment, Proposed National Instrument 55-104 Insider Reporting Requirements and Exemptions, Companion Policy 55-104CP Insider Reporting Requirements and Exemptions and Related Consequential Amendments* (2008) 31 OSCB 12117 at 12150, Proposed Item 17, Form 51-102F5.

[71] Notice of NI 55-104*, supra* n 35 at 673.

[72] British Columbia Securities Commission, *'08/'09 Annual Report*, (Vancouver: BCSC, 2009), online: British Columbia Securities Commission <http://www.bcsc.bc.ca/uploadedFiles/BCSC_Annual_Report_2008_2009.pdf> at 17.

[73] *Workum and Hennig (Re)* (7 June 2008), 2008 ABASC 363, online: Alberta Securities Commission <http://www.albertasecurities.com>.

their reporting obligations, since they had properly reported insider trades made through other accounts. Commission staff had reviewed the company's financial documents and identified certain misrepresentations.[74] Again, however, breach of the insider reporting rules was only one part of a larger case involving allegations of market manipulation, inaccurate financial disclosure and a pattern of making misrepresentations to Commission staff.

The OSC monitors continuous disclosure filings of reporting issuers as well. According to the OSC's 2009 Annual Report, in 2008-09,

> the OSC conducted reviews of the information publicly disclosed by 100 public companies. These companies accounted for approximately 52% of the total market capitalization of Ontario-based companies listed on the Toronto Stock Exchange and TSX Venture Exchange as at September 30, 2008.[75]

The report does not disclose, however, whether the OSC's continuous disclosure review extends to insider reports.

The British Columbia Securities Commission similarly conducts random audits of reporting issuers' financial documents. Throughout the fiscal year, the Corporate Finance division reviews issuer disclosure for non-compliance. Non-complying issuers receive comment letters. Those issuers that receive letters are audited at the end of the fiscal year by

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[74] *Ibid.* at para 1275.
[75] Ontario Securities Commission, *Annual Report 2009*, (Toronto: OSC, 2009) at 37, online: Ontario Securities Commission <http://www.osc.gov.on.ca/static/_/AnnualReports/2009/files/OSC_AnnualReport.pdf> at 37.

an independent auditor.[76] However, since it is the issuer's documents that are the focus of the audit, the review is unlikely to extend to insider reports.

As discussed below, if the obligation to file insider trading reports with respect to option grants fell upon the issuer rather than the insider, such continuous disclosure reviews could prove much more effective in detecting and deterring options backdating. In Australia, for instance, a corporation must notify the Australian Stock Exchange of any changes in major shareholders' or directors' interests. The Australia Securities and Investments Commission can then readily cross reference the corporation's documents to insider reports.[77] In a 2005 media release, Eric Mayne explained, "When a director does not comply with a simple requirement, it raises the perception of potential market misconduct, and we will ask why the notice was not lodged, and if there is evidence of misconduct then we will intervene accordingly."[78]

<u>(VI) Conclusion and Recommendations</u>

The insider reporting requirements were not originally designed to deter or detect options backdating, and appear to have been traditionally regarded by securities regulators chiefly as an administrative filing requirement that has not been the subject of vigorous

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[76] British Columbia Securities Commission, *Annual Report 2007/08*, (Vancouver: BCSC, 2008), online: British Columbia Securities Commission <http://www.bcsc.bc.ca/uploadedFiles/BCSC_Annual_Report_2007(1).pdf> at 19.

[77] Australian Securities Exchange Listing Rules: Chapter 3 Continuous Disclosure, rr 3.19 and 3.19A, online: Australian Securities Exchange <http://www.asxgroup.com.au/media/PDFs/Chapter03.pdf >.

[78] Australian Securities and Investments Commission, Media Release, 05-324, "ASIC and the ASX urge directors to notify market operators of shareholdings" (19 October 2005), online: Australia Securities and Investment Commission <http://www.asic.gov.au/asic/asic.nsf/byheadline/05-324+ASIC+and+the+ASX+urge+directors+to+notify+market+operators+of+shareholdings>.

enforcement except in the most egregious cases of late or non-filing, or when a reporting failure is linked to a more significant breach of securities laws. Options backdating has now emerged as a significant problem, and regulators have identified insider reporting rules as a potential tool for combating such backdating. Accordingly, it would be useful for Canadian legislators and regulators to consider measures that would enhance the effectiveness of insider reporting rules in detecting and deterring options backdating.[79] Such measures could include the following:

(a) Shortening the period within which insider trading reports must be filed from five days after a purchase or sale to two days, harmonizing Canadian rules with federal U.S. securities law rules.

Heron and Lie[80] in a 2007 study demonstrate that most U.S. executives in their sample choose to delay reporting until the second day and that for these grants there still exists evidence of backdating. Further, a more recent study by Heron and Lie[81] shows that the percent of unscheduled grants backdated or manipulated fell dramatically following the introduction of the two-day rule. Extrapolating from this, it is appears insiders delay reporting as long as possible and a five-day window obviously gives insiders greater scope for backdating than a two-day window. As a consequence, the filing window for stock

[79] These recommendations are an abridged version of proposals previously advanced in a submission to the Canadian Securities Administrators by Compton, Sandler, and Tedds.
[80] Heron & Lie, "Does Backdating Explain", *supra* n 34.
[81] Heron & Lie, "What Fraction of Option Grants", *supra* n 34. See also Narayanan & Seyhun, "Effect of SOX", *supra* n 34.

option grants should be shortened to at most, two days and in fact, as discussed below, should be eliminated entirely.[82]

(b) Requiring reporting issuers granting options to insiders to issue a press release on the day of the grant

Reporting issuers should be required to issue a public press release on the day of an executive option grant (and any amendments to existing options). This is a requirement to which companies listed on the TSX Venture Exchange are currently subject.[83] Through this requirement, the ability to backdate should be eliminated completely and at a relatively low cost in terms of regulatory resources. It also improves greatly on the U.S. requirement that firms with corporate websites must make the option grant information available on their website on the day following their disclosure of information to the SEC.

(c) Imposing an obligation on reporting issuers, rather than insiders, to file insider reports in the case of the issuance of securities, including options, by the reporting issuer to an insider, with significant penalties for failure to file within the applicable time limits.

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[82] McNally & Smith, *supra* n 49 at 346, make recommendations along similar lines with respect to insider reporting of equity trades, arguing that for TSX trades insider reports should be made immediately through the TSX STAMP trading system to SEDI (which effectively shifts the reporting requirement from insiders to brokers). For trades outside of this system (e.g. private transactions and US-exchanges), the U.S. 2-day rule is advocated.

[83] TSX Venture Exchange Corporate Finance Manual, Policy 4.4, s 2.11, online: TSX-V <http://www.tmx.com/en/listings/venture_issuer_resources/finance_manual.html>.

As discussed above, the reporting obligation for executive stock option grants is placed on the corporate issuer in both the UK and Australia and it has been suggested that such obligation has likely precluded backdating from occurring in the UK.

The reporting issuer possesses all of the information concerning the grant of stock options to insiders and therefore is better placed to ensure that all such grants are reported on a timely and accurate basis. It should have no difficulty filing such reports on SEDI within a two-day reporting window. Indeed, it is arguable that the onus should be on the reporting issuer to file such reports on the day the options are granted. Reporting issuers should not have the *option* of filing such reports, as set out in NI 55-104.[84] Reporting by the reporting issuer should be mandatory and there should be sufficiently severe monetary penalties for failure to comply. Moving the responsibility from the individual to the corporation in the case of stock option grants would increase uniformity and timeliness of filing.

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[84] *Supra* n 39 and accompanying text.