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British Columbia Securities Commission
Alberta Securities Commission
Saskatchewan Financial Services Commission
Manitoba Securities Commission
Ontario Securities Commission
Autorité des marchés financiers
Nova Scotia Securities Commission
New Brunswick Securities Commission
Office of the Attorney General, Prince Edward Island
Securities Commission of Newfoundland and Labrador
Registrar of Securities, Government of Yukon
Registrar of Securities, Department of Justice, Government of the Northwest Territories
Registrar of Securities, Legal Registries Division, Department of Justice, Government of Nunavut

C/O

Noreen Bent
Manager and Senior Legal Counsel, Corporate Finance
British Columbia Securities Commission
PO Box 10142, Pacific Centre
701 West Georgia Street
Vancouver, British Columbia
V7Y 1L2

Me Anne-Marie Beaudoin
Corporate Secretary
Autorité des marchés financiers
800, square Victoria, 22e étage
C.P. 246, Tour de la Bourse
Montréal, Québec
H4Z 1G3

To CSA Member Commissions

We are writing in response to the Canadian Securities Administrators' request for comments on proposed national instrument 55-104 *Insider Reporting Requirements and Exemptions* and companion policy 55-104CP *Insider Reporting Requirements and Exemptions*.

Our interest and expertise in this area arises out of our individual and collective academic research on employee stock options in general and options backdating by Canadian companies in

particular. Stock option backdating appears to be one impetus for the proposed national instrument (see, e.g., paras. 5. and 6(c) of theRequest for Comments). Our comments on the proposed NI 55-104 focus on stock option backdating. These comments mirror some of those found in our forthcoming paper "Options Backdating: A Canadian Perspective" which will appear in the *Canadian Business Law Journal* in 2009.

Canada is not immune to the backdating scandal that has unfolded in the United States in recent years. Indeed, research that we are undertaking at the moment will demonstrate that the incidence of backdating in Canada is much broader than the very few Canadian companies that have to date publicly announced inappropriate backdating behaviour.

The question is what can be done to reduce option backdating? From our review of the current state of affairs in Canada, as well as that south of the border, a number of policy options are worth considering, some of which are considered in proposed NI 55-104.

Reporting Window

As a result of the *Sarbanes-Oxley Act*, the U.S. Securities and Exchange Commission (SEC) reporting regulations now require executive stock option grants to be reported to the SEC within two business days of receiving the grant. A recent study by Heron and Lie[1] shows that with the introduction of this new two-day reporting period, the return pattern associated with backdating is much weaker. A more recent study by Heron and Lie[2] shows that the percent of unscheduled grants backdated or manipulated fell dramatically following the introduction of the two-day rule. The move to a two-day rule obviously provides a much smaller window to opportunistically backdate option grants and still meet the reporting requirements.

NI 55-104 proposes to reduce the reporting window from ten days to five days. The proposed reduction in the reporting window should reduce the ability to manipulate stock option grants in Canada, although not to the same extent as a U.S. two-day window. In their 2007 study, Heron and Lie[3] show that most U.S. executives in their sample choose to delay reporting until the second day and when the option grant is reported two days after the grant, there still exists statistically significant evidence of backdating. As a consequence, we would urge you to consider accelerating the filing window beyond the proposal five days to, at a minimum, match that which exists in the U.S.

However, in our view, the onus for filing employee stock option grants should rest on the corporation and not on the insider. Furthermore, as discussed in greater detail in the next section, that obligation should arise on the day the options are granted. There should be no filing window at all.

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[1] R.A. Heron and E. Lie, "Does Backdating Explain the Stock Price Pattern Around Executive Stock Option Grants" (2007), vol. 83, no. 2 *Journal of Financial Economics* 271-295.
[2] R.A. Heron and E. Lie, "What Fraction of Stock Option Grants to Top Executives Have Been Backdated or Manipulated?" (Forthcoming) *Management Science*.
[3] Supra note 1.

Reporting Obligation

Under the SEDI system, the responsibility for filing insider reports rests with the executive receiving the option grant. However, it is quite common that such filings are made long after the 10-day reporting window has expired, if at all.[4] In addition, such reports are often missing information (e.g. the exercise price) or include incorrect information (e.g. misreporting the grant date). This non-uniformity in data entry reduces transparency and potentially allows for greater opportunity for filing misconduct. Filing an insider report in SEDI when an option is granted is not an onerous task and there is no reason why an insider cannot file a completed report within two days of the option grant, *assuming the insider has been notified immediately of the option grant*. In the course of our research, we have become aware of numerous incidences where it is apparent that the insider was not notified of the option grant in a timely fashion to ensure compliance with the filing requirement. We have several suggestions for you to consider in order to ensure that insiders are informed and that reports are filed, with complete and accurate information, in a timely manner.

First and foremost, we suggest that the reporting requirement for stock option grants (as well as all amendments to previous stock option grants) should rest with the corporation and not the insider. The corporation 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 corporation to file such reports on the day the options are granted. Reporting issuers should not have the option of filing such reports, as is proposed in NI 55-104 (see further below). Reporting by the corporation should be mandatory and the legislation should include sufficiently severe monetary penalties for failure to comply. Moving the responsibility from the individual to the corporation in the case of stock option grants will increase uniformity and timeliness of filing.

Second, companies granting executive stock options 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 the practice currently in place for companies listed on the TSX Venture Exchange. 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.

In both cases (the reporting obligation on SEDI as well as the press release), the consequences (i.e., penalties) attached to a failure to comply must be sufficiently meaningful to promote compliance. Heron and Li[5] among others show clearly that the evidence of backdating is amplified when the report of an option grant is filed late. It is our understanding that currently, late reporting results in a fine of $50 per day to a maximum of $1,000 per firm. This does not appear to be a terribly biting punishment, even if rigorously enforced.

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[4] It is apparent that insider reports are missing when comparing SEDI reports to annual reports filed by issuers on SEDAR.

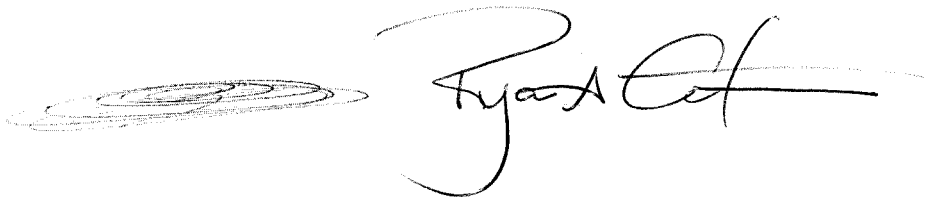
[5] Supra note 1.

Compliance is obviously directly related to the ability of the relevant securities body to enforce the reporting requirements. There is little ability under the current system to know if insider reports are being filed at all. In our research, we have compared the insider reports filed on SEDI with the compensation information provided by select companies in their annual reports filed on SEDAR and have found several incidences of failure to report option grants on the SEDI system. Further, despite there being numerous cases of late filing on SEDI, it is not clear whether filings are detected by the appropriate securities regulator and if so, whether fines have been levied. While we agree with the proposal to require an issuer to disclose if any of its insiders have been subject to late filing fees (if the onus to report option grants is not shifted from the insider to the issuer corporation), we urge the CAS member commissions to significantly increase monitoring and enforcement measures to ensure compliance with the reporting requirements. As an initial measure, we suggest that SEDI should not accept a report of stock options grants to an insider unless all of the required information is included in the report.

As noted above, NI 55-104 proposes to give issuers the option of reporting stock option grants on SEDAR and, where such reports are filed, the insider need only file an annual report on SEDI. We are concerned about this proposal because it will lead to information related to insider transactions not being available in one place. The current advantage of SEDI is that it allows interested parties to obtain from one source information related to not only stock option grants but also any repricing and exercises. By permitting some issuers to file option grants on SEDAR only, necessarily implies that the full historical picture that is available on SEDI will be lost and increases the cost of obtaining the information to interested parties. We strongly urge you to reconsider this proposal.

We thank you for the opportunity to provide you with comments on proposed NI 55-104 and companion policy 55-104CP. Please do not hesitate to contact us should you have any questions or require further information.

Sincerely,



Daniel Sandler
Professor
Faculty of Law
The University of Western Ontario
London, Ontario
CANADA N6A 3K7

Lindsay Tedds
Assistant Professor
School of Public Administration
University of Victoria
PO Box 1700 STN CSC
Victoria, BC V8W 2Y2

Ryan A. Compton
Assistant Professor
Department of Economics
University of Manitoba
Winnipeg, Canada, R3T 5V5