March 27, 2009

DELIVERED BY EMAIL

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
E-mail: nbent@bcsc.bc.ca

Madame Anne-Marie Beaudoin
Corporate Secretary
Autorité des marchés financiers
800, square Victoria, 22e étage
C.P. 246, Tour de la Bourse
Montréal, Quebec H4Z 1G3
E-mail: consultation-en-cours@lautorite.qc.ca

Dear Members of the Canadian Securities Administrators:

Re: Notice and Request for Comment – Proposed National Instrument 55-104 Insider Reporting Requirements and Exemptions and related consequential amendments

We welcome the opportunity to comment on the Canadian Securities Administrators ("CSA") proposed National Instrument 55-104 *Insider Reporting Requirements and Exemptions* and related instruments, which was published for comment on December 19, 2008.

Veritas Investment Research is a Toronto based, independent equity research firm specializing in business analysis, accounting and valuation. Our clients include a broad range of North American institutional money managers, retail advisors and Canadian

regulatory bodies. Our research is intended to provide our clients with an objective and forthright discussion of business fundamentals, accounting and financial reporting issues.

Veritas' Interest in Insider Filings

On September 8, 2006, on the heels of the growing backdating investigation in the United States, Veritas published a look at the potential fallout for Canadian companies titled: "*Stock Option Backdating: Could it Happen Here?",* examining Canada's filing rules for stock options and insider trades.

Our intention was to highlight potential pitfalls in Canada's regulatory framework for insider filings and present evidence from our study of S&P/TSX 60 options grants which suggested that the bad behaviour evident in the U.S. was very likely occurring in Canada. (Electronic copies of our 2006 study are available on request.)

Our methodology borrowed heavily from the academic work of Randall Heron and Erik Lie, who first illustrated the U.S. backdating problem using simple statistical techniques. Examining U.S. grant data, the authors found that related share prices dropped systematically in the thirty days before the registered date of options grants, and rose systematically after the date of the grant, something that could not have happened by chance.

The pattern was most pronounced in the era when U.S. companies had until the end of the fiscal year to file their options grants, giving them ample opportunity to retroactively pick favourable grant prices. Heron and Lie also found that the statistical "V" that characterized prices around the grant date all but disappeared after the 2002 introduction of the Sarbanes-Oxley requirement to file these grants within two days.

The prevailing belief in this country, where the filing window was already 10 calendar days by 1999, was that backdating was not likely to be an issue for Canadian filers.

Conclusions of the Veritas 2006 Report

Our study of Canadian S&P/TSX 60 options grants showed the same "V" shaped pattern as the Heron and Lie studies, signaling that Canada did in fact have an options problem. On average, prices were 50 basis points higher 10 days before grant dates and more than 100 basis points higher 15 days after grant dates. The pattern suggested that options grant dates:

1. May have been willfully manipulated by selecting share price lows during the 10 day regulatory window or from a window extended by filing the grants late; or

2. The options may have been timed to game material information, either to precede good news or follow bad news, under practices known as *spring-loading* or *bullet-dodging*.

Picking out specific offenses is problematic, however. While stock prices can be tracked in and around grant dates, coincidence is a powerful defense. In addition, grants to insiders generally occur in small batches, limiting the data available on individual filers. In most cases, a definitive judgment requires a paper trail that is internal to the company.

In the end, given the circumstantial nature of individual grants, rather than accusing specific companies, our report was content to highlight the problem and hope that regulators would move to shore up the system, an effort which is now underway.

In general, we agree with the approach being taken in the proposed instruments but we would like to make two major recommendations. The new rules should:

1) Require option grant terms to be set at the time the grants are publicly disclosed; and

2) Track the grant dates and terms of all equity linked compensation.

Our recommendations are outlined in more detail below.

Recommendation: Require grant terms to be set at the time of disclosure

We see an effective system of insider filings as consisting of three main goals:

1) **Full disclosure** of insider option grants and equity trading activity,

2) **Limited delay** between the disclosure of, and the setting of terms for, share and equity linked compensation, primarily to prevent backdating and insider abuse of material non-public information; and

3) Achievement of **lowest cost compliance**.

Two options stand out as sensible for meeting these goals:

1) **Require that option grant prices and terms be set on the date they are filed with regulators.** This would be achieved, for example, by setting grant prices as of the close of business on the date the grant is filed on SEDI. This method is transparent and eliminates all opportunities to backdate. It also eliminates the need for late filing fees, since the terms of various grants would only come into effect on the date they are filed with regulators, creating a strong incentive to file option grants sooner and more accurately.

2) **Require that option grant prices and terms be set in a public press release.** In this case, the grant terms take effect on the day of the press release, and can be filed with regulators at a later date without possibility of manipulation; potentially even once a year to reduce compliance costs. This press release requirement is currently in place for companies listed on the TSX Venture Exchange.

Under currently proposed rules, whether 5 days or 10 days, if insiders file late then *the window for backdating is extended to the date of actual filing*, allowing a much greater opportunity for abuse. Certainly the penalties for late filing are not significant enough to dissuade this behaviour. Both of the options above close this loophole.

Recommendation: Track all equity linked compensation

The second issue examined by our 2006 study was how to treat a new breed of options that do not always result in the purchase of shares. Many companies are converting their conventional options, which grant the right to buy shares at a specified price, into plans that provide a cash alternative, such as:

1. **Stock Appreciation Right or SARs**, which offer cash equal to the amount by which the share price exceeds the SARs issue price;

2. **Tandem Options**, which offer holders the choice between a SARs cash payment or a conventional option to buy shares at the grant price;

3. **Deferred Share Units or DSUs**, which are share linked units that offer a cash payment equal to or tied to the share price; or

4. **Performance Share Units or PSUs**, which are like DSUs but only vest when specified conditions are met (meeting earnings per share targets, for example).

These forms of compensation fall under the broad category of "cash settled options" and are preferred by companies because, under financial accounting rules, they can be expensed under the more favourable intrinsic value accounting method, rather than the more onerous fair value method.

Some argue that these forms of compensation are "just like cash bonuses", and therefore, like cash bonuses, should not be tracked by insider filings but instead by conventional rules for disclosing compensation. In our view, this does not take proper account of how dependent these 'bonuses' are on share prices. After all, the intent of these equity linked instruments is to compensate management when share prices rise, thereby aligning the recipient's interests with those of shareholders. Because of their link to equity prices, these options are just as prone to abuse as conventional options.

SARs and Tandem Options can be backdated in exactly the same way as conventional options by looking backwards and setting a price lower than the current share price. In

this way, when they are offered, management is already '*in-the-money*' and has earned compensation without effort. If SARs and Tandem options fall outside of the regular insider filing regime and are reported only in annual circulars, they will be prone to the same abuse as options were under the pre-2002 U.S. rules for filing options.

PSUs and DSUs are also subject to gaming. Consider the following example:

- Compensation disclosures in an April 15, 2009 Information Circular announce that insiders were granted 100,000 DSUs on January 1, 2009, with each unit having a value equal to the $10 share price on that day, resulting in total compensation of $1 million ($10 x 100,000 DSUs);
- Suppose, however, that the DSUs were not granted on January 1, 2009, and were instead backdated from March 31, 2009 when the DSUs were actually issued, when share prices were $20. The actual amount of compensation should have been disclosed as $2 million received on March 31, 2009 ($20 x 100,000 DSUs). The result is in an extra $1 million of undisclosed compensation for which insiders did no additional work.
- Really, this is no different than if these executives had been issued 100,000 options on March 31, 2009, while claiming the options were issued on January 1, 2009. The backdated options would have been $1 million in the money at March 31, the time of issue – the same as the extra compensation in our DSU example.

We hope this serves to illustrate our point that if backdating is the problem, then investors and regulators should also be concerned with the proliferation of other forms of compensation linked to share prices, since these are equally prone to abuse.

This means tracking the grant terms for these instruments on the same basis as conventional options. Otherwise, compensation will simply gravitate to forms featuring less oversight and disclosure, opening the door to a bigger problem.

In the case of SARs and Tandem options, it is sufficient to track grant date and grant price in the same way as conventional options.

In the case of DSUs and PSUs, investors need to know the terms and value of grants on the day they are issued to evaluate if they are above board. The conditions attached to PSUs, for example, also determine whether they are 'in the money' at the time of grant.

Concluding Remarks

In general, we agree with the changes proposed under National Instrument 55-104, including tightening the definition of insiders and allowing for alternate disclosures (i.e. 'issuer grant reports') within the same filing window.

While we view the reduction to a 5 day filing window for existing filers as a major improvement, it does not eliminate the opportunity to backdate options created by late

filings. Whatever the required filing window for transactions, the de facto filing window stretches to the point when the transaction is actually filed.

In our view, there would be no filing problem if the terms of compensation grants were publicly disclosed and verifiable at the date these arrangements are made. Setting the terms in a press release or at the time of the regulatory filing closes all backdating loopholes.

Finally, as we have argued, all forms of stock based compensation are subject to abuse and should therefore be tracked on the same basis.

We would be pleased to discuss any of our comments in greater detail. Please contact us if you require any additional information.

Best regards,

Sam La Bell

Vice-President

Veritas Investment Research Corporation
Canadian Pacific Tower, Toronto-Dominion Centre
100 Wellington Street West,
Suite 3110, PO Box 80
Toronto, ON
M5K 1E7

www.veritascorp.com

Phone: 416-866-8783
Fax: 416-866-4146
Toll Free: 866-640-8783