A Director's Guide to
EXECUTIVE COMPENSATION

THOMSON CARSWELL

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LEXPERT EVENTS

Compensation Disclosure and Reporting Gone Wrong

The Ramifications of Failing the Disclosure Obligations and Avoiding the Pitfalls

These quarterly newsletters provide practical advice and current legal comments on executive compensation and compensation governance and disclosure. These newsletters will be of interest to directors, executives, lawyers and human resources professionals.

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In our prior newsletter, we reviewed the various sources of compensation disclosure and insider reporting obligations. We learned that compensation information was disclosed to securities commissions and the public in various documents, including prospectuses, annual disclosure documents, press releases and insider trading reports.

Having reviewed the disclosure obligations, you may have been left wondering what happens when these obligations are not met. It is a good question – and the answer is: potentially lots, including being sued, fined and even imprisoned. This newsletter summarizes the potential consequences to directors, officers and reporting issuers who fail to meet their disclosure and insider reporting obligations, along with providing practical compliance tips to avoid any sanctions.

This newsletter focuses on the powers of the securities commission, the stock exchange and courts in Ontario, but other jurisdictions have similar powers. Although outside the scope of this newsletter, there are other enforcement agencies involved in the securities framework. These include various self-regulatory organizations that oversee the conduct of their members and can sanction them, such as the Investment Industry Regulatory Organization of Canada and Mutual Fund Dealers Association, along with the RCMP and local and provincial police units who can investigate commercial crimes, including market fraud. In fact, the RCMP's white-collar crime unit, the Integrated Market Enforcement Team, recently laid criminal charges against three former executives of Nortel Networks Corp. and six former executives of Royal Group Technologies Ltd. Both cases had been under investigation since 2004 and the charges related to allegations of fraud and fraud-

From the Editor

I am pleased to be the new General Editor of these newsletters and welcome you to our improved format. In our new format, I will continue to provide practical advice and legal commentaries on executive compensation. As a new feature, from time to time, comments, opinions and interviews with other executive compensation specialists will be included. This issue includes comments from John Tuzyk, a partner in the Securities Group at Blake, Cassels & Graydon LLP. Hopefully, you will find the new format interesting and your comments and ideas for topics are welcomed at nadine.cote@ca.ey.com or ncote@bell.blackberry.net. — *Nadine Côté LL.B.*

Key statistics from the Canadian Securities Administrators most recent annual enforcement report:

- Completed 58 cases involving 226 companies and individuals
- Issued 42 orders freezing assets or stopping individuals and companies from trading
- Monetary sanctions, settlements and disgorgements totaled about $6.3 million
- Criminal courts convicted 13 individuals and companies for violating securities laws
- Convictions resulted in jail sentences for individuals up to six months
- Fines for insider trading totaled $20,000 and costs totaled $5,000
- Fines for disclosure violations totaled $841,250 and costs totaled $1,265,000[2]

ulently misstating financial results.[1]

Most of what is set out below refers to the general enforcement powers of the securities commissions, stock exchanges and the courts; not the specific sanctions for failing to meet the compensation disclosure and insider reporting obligations. This is because the securities legal framework provides broad enforcement authority to commissions, exchanges and courts consistent with a principles-based approach to securities regulation, rather than listing specific sanctions for particular infractions. As a consequence, it is difficult to know in any particular situation what sanctions a commission, exchange or court will impose. What is known is that these authorities have extensive enforcement powers to impose sanctions with serious repercussions to a person or company.

Powers of the Commission

Default and Cease Trading Lists

Securities commissions have broad authority to administer and enforce securities laws. This includes the authority to hold hearings, order investigations and order financial examinations.[3] Securities commissions can also maintain lists of reporting issuers who are in "default" – that is, in default for failing to comply with securities laws. It is expressly recognized that the failure of a reporting issuer to meet its governance disclosure obligations, which includes compensation governance, may constitute a default.[4] Moreover, securities commissions can publish lists on their websites of those who are in default, along with publishing lists of reporting issuers, management and insiders who are subject to cease trade orders.[5]

Late Filing Fees

Securities commissions can impose fees for failing to file disclosure and insider reporting information on time. For example, the fee imposed by the Ontario Securities Commission for the late filing of Form 55-102F2 – Insider Report is $50 per calendar day, per insider, per issuer, subject to a maximum of $1,000 per issuer within one year from April 1 to March 31.[6]

Commission Orders

Securities commissions also have authority to make extensive interim or permanent orders that, in the commissions' opinion, are in the public interest. The authority to make orders in the public interest includes making orders to:

- Suspend a person's or company's registration or trading
- Prohibit someone from serving as a director or officer
- Pay the cost of the commission's investigation, hearing and legal services[7]

If a person or company has not complied with securities laws, further orders can be made to:

- Amend documents, such as a prospectus or an information circular
- Pay an administrative penalty up to $1 million for each failure to comply
- Disgorge amounts obtained from the non-compliance[8]

Powers of the Court

Court Orders

Courts also have authority to make extensive interim or permanent orders. Courts can make orders after hearing an application made to determine if a person or company has complied with or is complying with securities laws. The court's authority includes making orders to:

- Rescind a transaction relating to trading in securities including issuing securities
- Issue, purchase, cancel, exchange or dispose of any securities
- Prohibit voting or exercising any other right attaching to the securities
- Pay general or punitive damages[9]

Fines and Imprisonment

A person or company may face fines or imprisonment, in addition to the orders of a commission or court. Fines can be issued or imprisonment ordered if a person or company commits an offence under securities laws.

It is an offence under the *Securities Act* to contravene securities laws. It is also an offence to make a statement:

- in any material, evidence or information submitted to the securities commission, or
- in a statement in a press release, prospectus, financial statement, takeover bid or issuer bid circular, information circular or other document that is required to be filed with the securities commission

that, in a material respect and at the time and in light of the circumstances under which it is made, is misleading or untrue or does not state a fact that is required to be stated or necessary to make the statement not misleading.

This offence can apply in respect of compensation disclosure and insider reporting because this information is submitted to the commission and available to the public. Guilt for the offence can extend beyond the director or officer who provided the misleading information to those who authorized, permitted or acquiesced in the commission of the offence. If found guilty of this offence, a person or company can be subject to:

- A fine up to $5 million
- Imprisonment up to five years
- Both[10]

For those in a special relationship with a reporting issuer, it is also an offence to:

- buy or sell securities of the reporting issuer with knowledge of a material fact or material change about the reporting issuer, or
- inform someone else of such material fact or material change [tipping]

if the material fact or material change has not been generally disclosed.

If found guilty of this offence, a person or company can be subject to:

- A minimum fine equal to the profit made or the liability avoided by the contravention
- A maximum fine equal to, the greater of, $5 million and an amount equal to triple the profit made or the loss avoided by the contravention[11]

Damages for Civil Liability

In the primary market, shares are bought from the public company issuing the shares and investors place orders with their brokers to acquire the shares. The primary market has for some time been subject to civil liability. The *Securities Act* generally provides that if there is a misrepresentation in a prospectus or an offering memorandum, purchasers who buy those securities during the period of distribution have a right of rescission or a right of action for damages against, among others, the issuer, and also against the underwriter and directors of the issuer when the securities are offered by a prospectus. If the misrepresentation is in a take-over bid circular, the security holders of the offeree issuer have a right of rescission or a right of action for damages against the offeror or the directors, among others.[12]

In the secondary market, investors buy and sell shares from one another through stock exchanges. Civil liability for continuous disclosure in the secondary market has been introduced in recent years, in a number of provinces. In general, in the secondary market, liability can arise when an issuer fails to make a timely disclosure of a material change as required by securities laws. Liability can also arise when the issuer releases a document with a misrepresentation. Further, liability can arise for misrepresentations in public oral statements relating to the business or affairs of the issuer by a person with actual, implied or apparent authority to speak on behalf of the issuer. Those who acquired or disposed of the security from the time the misrepresentation was made to when it was corrected may have a right of action, regardless of any reliance on the misrepresentation. The right of action for damages can extend to, among others, the issuer, the directors and the officers of the issuer who authorized, permitted or acquiesced in the release of the document or making of the public oral statement.[13]

Defences

Various defences may be available to those who are facing court imposed fines and imprisonment for securities violations or civil liability in the primary or secondary markets. For example, a person or company will not be liable for misrepresentations in the secondary market if before the release of the statement: a reasonable investigation was conducted; and, at the time of the release of the statement the person or company had no reasonable grounds to believe that the statement contained a misrepresentation.[14] These defences would be fully explored by any person or company facing sanctions.

Comments from John Tuzyk of Blake, Cassels & Graydon LLP

John, how do you foresee the new disclosure rules being enforced?

Based on past experience, it can be expected that the Canadian Securities Administrators (CSA) will undertake a continuous disclosure review of a number of issuers to assess compliance with the new requirements. This occurred the last time the executive disclosure rules were changed significantly. The SEC also did this when the U.S. introduced its new disclosure rules a couple of years ago.

Any perceived or possible non-compliance with the new requirements will be identified by the applicable CSA regulator in a letter to the relevant issuer identified for review, with a request for an explanation. If the CSA is not satisfied with the response, usually the issuer will indicate to the regulator it will improve its disclosure in the next annual circular. In rare cases, where the omission or misstatement is regarded as being material, the CSA regulator might require immediate corrective public disclosure, resulting in expense and embarrassment for the issuer and its directors. In addition, the matter might be referred to the enforcement branch of the regulator.

If an issuer is found not to have complied with the requirements, or has made a statement in an information circular that was in a material respect misleading, it is potentially liable under securities legislation for payment of investigation costs and fines, and officers and directors may be also be subject to cease trade orders and orders prohibiting them from serving as directors or officers of issuers. In presumably rare and appropriately serious cases, the legislation provides for imprisonment up to five years.

In addition to possible regulatory sanctions, provisions in the securities legislation of a number of provinces provide for personal civil liability for misrepresentations in documents released by issuers, such as circulars and annual information forms. Directors and officers who approved, or acquiesced in, such statements (and given directors approve the information circular they would be responsible for misrepresentations in it) may be subject to personal damages claims, subject to due diligence and other defences. Such claims would likely be brought in a class actions suit, as has been the case in the U.S. and in a few cases in Canada in alleged non-disclosure cases.

Thanks to John Tuzyk, partner in the Securities Group of Blake, Cassels & Graydon LLP.

Powers of the TSX

Suspend or Halt Trading & Delist Securities

The Toronto Stock Exchange (TSX) can impose sanctions on reporting issuers who fail to comply with its requirements, in addition to any sanctions imposed by securities commissions and courts under securities laws. The TSX has the general authority to:

- Temporarily halt trading in any listed issuer's securities
- Suspend from trading and delist a listed issuer's securities if the listed

issuer failed to comply with its listing agreement or any other TSX requirement and such action is necessary in the public interest.[15]

The TSX has adopted some criteria for when it will consider a suspension from trading and a delisting of securities. The criteria are not determinative and each situation must be considered based on its own facts.[16] Nonetheless, the TSX has specifically stated that the failure to comply with the TSX's requirements for stock options and other security based compensation may result in the delisting of the listed issuers securities.[17] In addition, a listed issuer may be ordered to improve or republish its disclosure or its name may be published or referred to the Ontario Securities Commission.[18]

Practical Tips to Ensure Compliance

The following practical measures should be taken to assist directors, officers and reporting issuers in meeting the compensation disclosure and insider reporting obligations. Establishing a system to ensure compliance with these obligations can also be of assistance in defending a claim for misrepresentations or failure to make timely disclosure in the secondary market.[19]

- Specify in written job descriptions the persons responsible for ensuring compliance with the company's continuous disclosure obligations, including those authorized to make public statements, orally and in writing, about the issuer. More than one person should be designated with these responsibilities so there are no delays in issuing any required press releases due to an individual's unavailability.
- Notify employees in writing which individuals are responsible for overseeing compliance with the continuous disclosure obligations and authorized to make public statements. Inform employees that any inquiries pertaining to these issues should be directed to the designated individuals.
- Notify employees in writing that other than the designated individuals, employees are not authorized to make public statements about the company in any manner, including orally, in writing or in email or internet communications, particularly any statements that could affect the value of the company's securities.
- Educate those responsible for overseeing compliance with the continuous disclosure obligations, along with other senior officers, on what the continuous disclosure obligations are and, specifically, what may constitute a material change or material information requiring public disclosure.
- Institute an internal review system and external expert review system to review all public statements, whether written or oral, before their release. Document the review process in writing.
- Institute a remedial process to ensure that any misrepresentations or failures to make timely disclosure are corrected as soon as possible.
- Institute a written disclosure policy setting out the foregoing and communicate the policy to employees.

A comprehensive review of compensation disclosure and insider reporting obligations and the consequences of non-compliance with those obligations is available in the regularly updated loose-leaf book published by Carswell, a Thomson Reuters business, titled "***Executive Compensation: A Director's Guide***" by Nadine Côté.

The following is provided for information purposes only. It does not constitute legal, tax, accounting, compensation consulting or other professional advice and cannot reasonably be relied upon as providing such professional advice. Kindly contact your service professional for any such advice.

1 Paul Waldie, "How IMET Found Its Groove" *The Globe and Mail* (20 June 2008).

2 Canadian Securities Administrators "*Report on Enforcement Activities from April 1, 2007 to September 30, 2007*", online: http://www.csa-acvm.ca/pdfs/Enforcement_Report_Apr-Sept2007_Eng.pdf

3 *Securities Act*, R.S.O. 1990, c. S.5 at ss. 3.2, 3.5, 11 and 12 [*Securities Act*].

4 Canadian Securities Administrators Notice 51-322 – *Reporting Issuer Defaults* (2007) 30 O.S.C.B. 4 [CSA 51-322] at ss. 1(m) and 4. National Instrument 58-101 *Disclosure of Corporate Governance Practices* (2005) 28 O.S.C.B. 5377.

5 CSA 51-322. *Securities Act, supra* note 3 at s. 72(9). Ontario Securities Commission Policy 57-603 – *Defaults by Reporting Issuers in Complying with Financial Statement Filing Requirements* (2001) 24 O.S.C.B. 2705 at ss. 1.1, 4.1 and 6.1.

6 Ontario Securities Commission Rule 13-502 *Fees* and companion Policy 13-502CP – *Fees* (2006) 29 O.S.C.B. 2333 Appendix D – Additional Fees for Late Document Filings at s. B, see the appendix for the exceptions. Also insiders may seek a waiver request for SEDI late fees. Form 55-102F2 – *Insider Report* (2003) 24 O.S.C.B. 6325 as am.

7 *Securities Act, supra* note 3 at ss. 127 and 127.1.

8 *Ibid* at s. 127.

9 *Ibid* at s. 128.

10 *Ibid* at s. 122(3)(4).

11 *Ibid* at s. 122(4).

12 *Ibid* at ss. 130, 130.1 and 131.

13 *Ibid* at s. 138.3(1)(2)(4).

14 *Ibid* at s. 138.4(5)(6).

15 Toronto Stock Exchange, *TSX Company Manual* (Toronto: CCH, 2006) at s. 701 [*TSX Company Manual*].

16 *Ibid* at s. 706.

17 *Ibid* at ss. 713 and 714.

18 Summary of 2005 TSX Corporate Governance Disclosure Survey online: http://www.tsx.com/en/pdf/TSXCorpGovSurvey2005.pdf

19 *Securities Act, supra* note 3 at s. 138.4(7).