A Director's Guide to
EXECUTIVE COMPENSATION

THOMSON REUTERS®

Volume 11, No. 2 Winter/Spring 2017

Insiders and Whistleblowers

This newsletter provides highlights of some of the recent publications from the Ontario Securities Commission (OSC) on insider reporting. They are useful guides to ensuring issuers and insiders meet their insider reporting and continuous disclosure obligations. This newsletter also comments on the whistleblower program recently introduced by the OSC and the very successful program introduced by the United States Securities and Exchange Commission (SEC). Interestingly, the SEC noted that nearly 65% of its tips from whistleblowers come from insiders about the entities where they work.

OSC on Insider Reporting

On February 18, 2016, the OSC released Staff Notice 51-726 — Report on Staff's Review of Insider Reporting and User Guides for Insiders and Issuers.[1] The purpose of the review was to assess compliance and assist reporting insiders with meeting their reporting obligations.

The review provided the following comments on the importance of insider reporting:

1. It deters insiders from improperly trading based on material undisclosed information.
2. It provides investors with timely information about the trades of insiders, which by inference may reflect their views of the issuer's future performance.
3. It discourages improper activities involving stock options and other equity-based compensation, such as stock option back-dating and repricing, due to the requirement for timely disclosure of such events.
4. All of the above contribute to the overall effectiveness and reliability of the market.

The report provided the following helpful summary of the key regulatory requirements and guidance on insider reporting:

1. Ontario *Securities Act* – sets out the general insider reporting requirements. An initial insider report must be filed within 10 calendar days of becoming an insider and subsequent changes in the insider's holdings must be filed within 5 calendar days.
2. National Instrument 55-104 — *Insider Reporting Requirements and Exemptions* — consolidates the key

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.

Nadine Côté is an employment and executive compensation lawyer at CSuite Law. She is also the author of Executive Compensation: A Director's Guide, the only comprehensive book in Canada on executive compensation.

General Editor & Author
ncote@csuitelaw.com

CONTENT

From the Editor

This newsletter highlights some of the recent OSC reports that guide issuers and insiders through their insider reporting and continuous disclosure obligations. This newsletter also comments on the recently introduced whistleblowing program of the OSC and the tremendously successful whistleblowing program of the SEC that was introduced in 2011. It will be interesting to monitor the OSC's whistleblower program to see if it achieves a level of success comparable to the SEC's program.

CSuite Law, First Canadian Place, 100 King Street West, Suite 5700, Toronto ON M5X 1C7 www.csuitelaw.com
— *Nadine Côté LL.B.*

reporting requirements across Canadian jurisdictions. It defines a "reporting insider' generally to include persons with routine access to material, undisclosed information concerning a reporting issuer or significant influence over a reporting issuer.

3. National Instrument 55-102 — *System for Electronic Disclosure by Insiders (SEDI)* — sets out the process for filing insider reports including reporting securities trading.
4. National Policy 51-201 — *Disclosure Standards* — sets out the best disclosure practices, including provisions on insider trading policies and black-out periods.
5. CSA and OSC Staff Notices on insider reporting.

The OSC conducted an issue-oriented review of the continuous disclosure records and insider filings of 100 reporting issuers whose principal regulator is Ontario. This resulted in a corresponding review of approximately 1,500 reporting insiders. On average, each reporting issuer had 15 reporting insiders. Sixty-five per cent were non-venture issuers and 35% were venture issuers.

The OSC reviewed the continuous disclosure documents on the System for Electronic Document Analysis and Retrieval (SEDAR) compared with the information reported on SEDI. The OSC also reviewed the insider trading policies of the reporting issuers against the best practices set out in National Policy 51-201 — *Disclosure Standards*.[2] The OSC corresponded with all of the reporting issuers and with approximately 530 reporting insiders or their filing agents about the SEDI filings.

The review determined that approximately 85% of the reporting insiders were materially compliant. However, approximately 15% had material deficiencies, which resulted in insiders filing new insider reports on SEDI. Generally, these reporting insiders were subject to late filing fees under section 10.1(2) of Companion Policy 55-104CP — *Insider Reporting Requirements and Exemptions*.[3]

The following are some of the key findings:

- About 30% of issuers had at least one reporting insider that did not have an insider profile and failed to file insider reports on SEDI.
- About 65% of the issuers had at least one reporting insider that had a discrepancy of at least 5% between the balances of the securities reported on SEDI versus the continuous disclosure records of the issuer. The majority of the variances were in the holdings of common shares (37%) followed by stock options (30%), deferred share awards, restricted share awards and performance share awards (totaling 20%) and the remainder (13%) related to other variances. Among the explanations provided, some stated they were unaware they were reporting insiders and others were unaware that if they held more than 10% of the outstanding shares of the issuers through a holding company that the holding company also had to have its own insider profile and file its own reports.
- About 500 insiders had to update their profile on SEDI to disclose they were no longer reporting insiders — which reports ought to have been filed within 10 days of ceasing to be reporting insiders.
- About 300 insiders had to update their contact information, which was out of date.
- About 40% of the reporting issuers had to update their security designations. The majority that required updating were issuer derivative securities (e.g. stock options, restricted share awards, deferred share awards and performance share awards).
- Only 10% of issuers filed issuer grant reports since January 2014. The review noted that issuers should consider filing an issuer grant report within 5 days of a grant to help avoid late fees being charged against its insiders.
- About 85% of issuers had written trading policies. However, certain policies did not restrict derivative-based transactions or the grant of stock options or similar forms of stock-based compensation during blackout periods.

OSC Annual Report

On July 28, 2016, the OSC released Staff Notice 51-725 — *Corporate Finance Branch 2015-2016 Annual Report*.[4] The report includes helpful tips for issuers and insiders with respect to their reporting obligations.

This report reminds issuers that they can file an issuer grant report pursuant to National Instrument 55-104 — *Insider Reporting Requirements and Exemptions*, which may grant insiders the benefit of delayed reporting for deferred share units, restricted share awards, stock options and stock appreciation rights.[5]

It also reminds insiders that deferred share units, restricted share awards and other similar securities must be accounted for under the security category of "issuer derivative", not under the category of 'equity'.

The report comments on the definitions of "reporting insider", "significant shareholder", and "beneficial ownership" and reminds insiders that if an individual holds more than 10% of the outstanding shares of an issuer through a holding company, then the holding company is also a "significant shareholder" and must also file an insider profile.

OSC Whistleblower Program

On July 14, 2016, the OSC launched the Office of the Whistleblower and the published OSC Policy 15-601 — *Whistleblower Program*.[6] The whistleblower program offers compensation of up to $5 million to individuals who provide the OSC with tips that lead to enforcement action. These could include tips on possible violations of Ontario securities law, such as insider trading, market manipulation and disclosure violations.

To protect whistleblowers, the program permits anonymous reporting by whistleblowers represented by a lawyer. As well, anti-reprisal provisions were added to the *Securities Act* (Ontario) to prohibit retaliations against whistleblowers in the workplace.[7] These protections apply even if the tips do not result in enforcement action or do not meet the criteria for an award.

Specifically, the *Securities Act* (Ontario) states that a company cannot take a reprisal against an employee of the company because the employee:

(a) Sought advice about providing information, expressed an intention to provide information or provided information to a person, company,

the OSC, a self-regulatory organization or a law enforcement agency about acts that the employee reasonably believes are contrary to Ontario securities law or a by-law of a self-regulatory organization; or

(b) Co-operated or expressed an intention to co-operate in an investigation or proceeding in relation to the foregoing acts.

Prohibited reprisals against employees include ending the employee's employment, demoting or disciplining the employee or intimidating the employee.

The *Securities Act* (Ontario) also provides that terms in employment agreements, including confidentiality agreements, are void if they: preclude the employee from providing the information described in paragraph (a) above to the OSC, a self-regulatory organization or a law enforcement agency; or if they prohibit the employee from co-operating in the investigation or proceeding described in paragraph (b) above.

It will be interesting to monitor this program over time to see if it has the success of a similar program introduced by the SEC, which is described in the following section.

SEC Whistleblower Program

The introduction of the OSC's whistleblower program in 2016 follows the introduction of a whistleblower program by the SEC in August 2011. The mission of the SEC's program is to help identify and halt frauds early and quickly to minimize investor losses. The SEC's program provides awards to whistleblowers equal to 10% to 30% of the monetary sanctions collected. As described below, based on the program's most recent annual report, the program has been extremely successful in many ways.

In November 2016, the SEC's Office of the Whistleblower released its *2016 Annual Report to Congress on the Dodd-Frank Whistleblower Program*. The report contains a depth of interesting information and statistics.[8]

The transformative effect of the program is demonstrated by the hundreds of millions of dollars that have been returned to investors. To date, the SEC enforcement sanctions brought with the assistance of the information and assistance provided by whistleblowers has resulted in over US$584 million in financial sanctions, including more than US$364 million in disgorgement of ill-gotten gains and interest.

In its short existence, the program has already paid over US$111 million to 34 whistleblowers. In fiscal 2016 alone, the program awarded over US$57 million to 13 whistleblowers. The ten highest awards were each over US$1 million with the largest over US$30 million. The award recipients were mostly from the United States, though eight were from abroad, including the recipient of the highest award.

In fiscal 2016, the number of tips received rose to over 4,200, including over 60 from each of Canada and the United Kingdom, over 50 from Australia and around 30 from each of Mexico and China. Within the United States, the jurisdictions with the greatest number of tips were California with over 500, followed by New York with nearly 300, and Ohio, Texas and Florida each with over 200.

Ontario Court of Appeal — Osgoode Hall

In fiscal 2016, nearly 60% of the whistleblowers who received awards provided original information that caused SEC Enforcement Staff to open an investigation, while the remaining 40% received awards because their information significantly contributed to an existing investigation. The information could contribute to an existing investigation by enabling the agency to bring the action in significantly less time or with fewer resources, by adding additional successful charges against existing respondents or by adding additional charges against new respondents.

Protecting Whistleblowers

Insiders reporting on the wrongdoings of the companies where they work have proven to be an invaluable source of information for the whistleblower program. The SEC commented that nearly 65% of the award recipients under the whistleblower program were insiders of the entity on which they reported information of wrongdoing. Interestingly, about 80% of these had raised their concerns to their supervisors or compliance personnel or understood that these individuals were aware of the wrongdoing, before they reported the wrongdoing to the SEC.

Considering the significant importance of insiders to the program's mission, it is not surprising the SEC has been vigilant in seeking sanctions against companies who retaliate against, or attempt to silence, current or former employees who are, were or may become, whistleblowers.

In September 2016, the SEC brought a first-of-its-kind enforcement action as a stand-alone whistleblower retaliation case against a casino-gaming company. The company agreed to pay a half-million dollar penalty for firing an employee, with several years of positive performance reviews, because the employee had reported to senior management and the SEC that the company's financial statements might be distorted.

Confidentiality & Severance Agreements cannot Silence Employees

The SEC has also taken on cases in which companies have attempted to end-run the SEC's whistleblower program by requiring employees to forego potential whistleblower awards as a condition to receiving their severance payments.

In September 2016, the SEC filed an action against a brewing company, Anheuser-Busch InBev SA/NV, in which the company agreed to settle charges it violated the Rules of the *Securities Exchange Act* by, among other things, entering into a separation agreement that stopped an employee from continuing to voluntarily communicate with the SEC due to a substantial financial penalty that would be imposed for violating strict non-disclosure terms. The company had entered into a separation agreement with an employee who had reported internally concerns about improper payments to government officials. The employee had also been communicating with the SEC, but ceased doing so upon entering into the separation agreement because he believed the confidentiality provisions prohibited such communications and he thought he could be liable for liquidated damages. The company subsequently amended its separation agreements for departing employees in the USA to specify that they do not prohibit employees from reporting possible violations of law to governmental agencies.

In fiscal 2016, the SEC also instituted proceedings against two companies for violations of the *Securities Exchange Act* Rules. One company settled with the payment of a US$265,000 penalty, on charges it violated the securities laws by using severance agreements that required outgoing employees to waive their rights to monetary recovery in the event they filed a charge or complaint with the SEC or other federal agencies. Another company agreed to pay a penalty of US$340,000 for illegally using severance agreements that required outgoing employees to waive their ability to obtain monetary awards from the SEC's whistleblower programs as a condition to receiving their severance payments.

The SEC has indicated that it will continue to assess confidentiality, severance and other kinds of agreements and practices that may stifle a would-be whistleblower from reporting information to the program and remove the very incentive the government intended to provide.

Endnotes:

1 OSC Staff Notice 51-726 — *Report on Staff's Review of Insider Reporting and User Guides for Insiders and Issuers*, online: http://www.osc.gov.on.ca/documents/en/Securities-Category5/sn_20160218_51-726_review-insider-reporting.pdf.

2 CSA National Policy 51-201 — *Disclosure Standards*, online: http://www.osc.gov.on.ca/en/SecuritiesLaw_pol_20020712_51-201.jsp.

3 CSA Companion Policy 55-104CP — *Insider Reporting Requirements and Exemptions*, online: http://www.osc.gov.on.ca/en/SecuritiesLaw_rule_20150625_55-104_consolidation-insider-rpt-req.htm.

4 OSC Staff Notice 51-725 — *Corporate Finance Branch 2015-2016 Annual Report*, online: http://www.osc.gov.on.ca/documents/en/Securities-Category5/rule_2016728_51-727_corporate-finance-branch-annual-report.pdf.

5 CSA NI 55-104 — *Insider Reporting Requirements and Exemptions*, online: http://www.osc.gov.on.ca/en/14014.htm.

6 OSC Policy 15-601 — *Whistleblower Program*, online: http://www.osc.gov.on.ca/en/SecuritiesLaw_20160714_15-601_policy-whistleblower-program.htm.

7 Ontario *Securities Act*, R.S.O. 1990, c. S.5, s. 121.5.

8 SEC *2016 Annual Report to Congress on the Dodd-Frank Whistleblower Program*, online: https://www.sec.gov/whistleblower/reportspubs/annual-reports/owb-annual-report-2016.pdf.