POLICY STATEMENT TO REGULATION 55-103 RESPECTING INSIDER REPORTING FOR CERTAIN DERIVATIVE TRANSACTIONS (EQUITY MONETIZATION)

The members of the Canadian Securities Administrators (the CSA) that have adopted Regulation 55-103 respecting Insider Reporting for Certain Derivative Transactions (Equity Monetization) (the Regulation) have adopted this Policy to clarify their views on several matters relating to the Regulation including:

- the regulatory objectives underlying the Regulation and the reasons why we feel the Regulation is necessary;
- the general approach taken by the Regulation to certain derivative-based transactions by insiders; and
- other information that we believe will be helpful to insiders and other market participants in understanding the operation of the Regulation.

PART 1 PURPOSE

1. What is the purpose of the Regulation?

We have developed the Regulation to respond to concerns that the existing insider reporting requirements in Canadian securities legislation may not cover certain derivative-based transactions, including equity monetization transactions (described below), which satisfy one or more of the fundamental policy rationale for insider reporting. We believe that timely public disclosure of such transactions is necessary in order to maintain and enhance the integrity of, and public confidence in, the insider reporting regime in Canada.

The Regulation seeks to maintain and enhance the integrity of, and public confidence in, the insider reporting regime in Canada by:

- ensuring that insider derivative-based transactions which have a similar effect in economic terms to insider trading activities are fully transparent to the market;
- ensuring that, where an insider enters into a transaction which satisfies one or more of the policy rationale for insider reporting, the insider is required to file an insider report, even though the transaction may, for technical reasons, fall outside of the existing rules governing insider reporting; and
- reducing uncertainty as to which arrangements and transactions are subject to an insider reporting requirement and which are not.

These objectives are discussed in greater detail below.

2. What are the current insider reporting rules?

Canadian securities legislation requires “insiders” of a reporting issuer (i.e., a public company) to file insider reports disclosing their ownership of and trading in securities of their reporting issuer (the insider reporting requirements).

The insider reporting requirements serve a number of functions, including deterring illegal insider trading and increasing market efficiency by providing investors with information concerning the trading activities of insiders of the issuer, and, by inference, the insiders' views of their issuer's prospects.

We have adopted the Regulation in response to the concern that the existing insider reporting requirements may not in all cases cover certain derivative-based transactions, including equity monetization transactions.

3. What are equity monetization transactions?

In recent years, a variety of sophisticated derivative-based financial products have become available which permit investors to dispose, in economic terms, of an equity position in a public company without attracting certain tax and non-tax consequences associated with a conventional disposition (e.g., a sale) of such position.

These products, which are sometimes referred to as "equity monetization" products, allow an investor to receive a cash amount similar to proceeds of disposition, and transfer part or all of the economic risk and/or return associated with securities of an issuer, without actually transferring the legal and beneficial ownership of such securities. (The term "monetization" generally refers to the conversion of an asset (such as securities) into cash.)

4. What are the concerns with equity monetization transactions?

Where an *insider* of a reporting issuer enters into a monetization transaction, and does not disclose the existence or material terms of that transaction, there is potential for harm to investors and the integrity of the insider reporting regime because:

- an insider in possession of material undisclosed information, although prohibited from trading in securities of the issuer, may be able improperly to profit from such information by entering into derivative-based transactions which mimic trades in securities of the reporting issuer;

- market efficiency will be impaired since the market is deprived of important information relating to the market activities of the insider; and

- since the insider's publicly reported holdings no longer reflect the insider's true economic position in the issuer, requirements relating to the public reporting of such holdings (e.g., an insider report or proxy circular) may in fact materially mislead investors.

Although we believe that many such transactions fall within the existing rules governing insider reporting, we accept that, in certain cases, it may be unclear whether the existing insider reporting rules apply. Accordingly, we have developed the Regulation to respond to this ambiguity.

The Regulation reflects a principles-based approach to monetization transactions and ties the obligation to report to the fundamental policy rationale underlying the insider reporting regime. Consequently, if an insider enters into a transaction which satisfies one or more of the policy rationale for insider reporting, but for technical reasons it may be argued that the insider falls outside of the existing insider reporting requirements, the insider will be required to file an insider report under the Regulation unless the insider is otherwise covered by one of the exemptions. In this way, the market can make its own determination as to the significance, if any, of the transaction in question.

5. **Does the Regulation prohibit insiders from entering into monetization transactions?**

No. The Regulation imposes a reporting requirement only. It does not prohibit insiders from entering into a monetization transaction. An insider may, however, be prohibited on other grounds from entering into a monetization transaction. For example, Canadian securities legislation generally prohibits insiders (and certain others) from trading in securities of a reporting issuer while in possession of material undisclosed information about that issuer (the insider trading prohibition). It should be noted that, in many cases, the scope of the insider trading prohibition is broader than the scope of the existing insider reporting obligation.

An insider may also be prohibited from entering into a monetization arrangement by the terms of an escrow agreement. The standard form of agreement prescribed by National Policy 46-201 *Escrow for Initial Public Offerings*, for example, contains restrictions on parties to the agreement entering into monetization arrangements.

6. **Why do investors enter into monetization transactions?**

Investors, including insiders, may have legitimate reasons for entering into monetization transactions. These reasons may include:

- *Tax planning* – where there has been significant appreciation in the value of securities held by an investor, a conventional disposition of such securities may trigger a significant tax liability; a monetization transaction may permit the investor to receive a cash amount similar to proceeds of disposition while deferring this tax liability.

- *Liquidity* – an investor may have a short-term need for cash and wish to borrow against his or her securities. A monetization arrangement may permit the investor to borrow an amount equal to a substantially higher proportion of the current market price of his or her securities (e.g., 90%) than he or she could with a simple pledge of the securities.

- *Retained ownership* – an investor may wish to monetize a portion of his or her position but retain the full voting rights and/or entitlement to dividends associated with that position.

- *Risk management/portfolio diversification* – an investor is able to "lock in" the present value of his or her position, and avoid the risk of a future decline in the value of the holding, by means of a monetization transaction. The investor may use the funds released as a result of the transaction to diversify his or her portfolio, thereby avoiding the risk of having all of his or her assets "in one basket".

7. **Does the requirement to report undermine any of these reasons for entering into a monetization transaction?**

No. A requirement to report the existence and material terms of a monetization transaction is not inconsistent with any of these objectives and does not prevent the insider from achieving any of these objectives.

8. **Does the Regulation apply only to monetization transactions?**

No. The Regulation applies to any agreement, arrangement or understanding which satisfies the conditions in section 2.1, 2.3 or 2.4 of the Regulation.

PART 2 APPLICATION OF THE REGULATION

1. **When does the Regulation apply?**

If you are an "insider" of a reporting issuer, and you enter into, materially amend or terminate an agreement, arrangement or understanding of any kind which

- changes your "economic interest in a security" of your reporting issuer, or
- changes your "economic exposure" to your reporting issuer, *and*

you are not required under any other provision of Canadian securities law to file an insider report about this agreement, arrangement or understanding, you must file an insider report under the Regulation, unless you are covered by one of the exemptions.

2. **What does "economic exposure" mean?**

The term "economic exposure" in relation to a reporting issuer is defined in the Regulation to mean the extent to which the economic or financial interests of a person or company are aligned with the market price of securities of the reporting issuer or the economic or financial interests of the reporting issuer.

The concept of "economic exposure" also appears in section 6.2 of National Policy 46-201 *Escrow for Initial Public Offerings*:

6.2 Restrictions on dealing with escrow securities

Escrow restricts the ability of holders to deal with their escrow securities while they are in escrow. The standard form of escrow agreement sets out these restrictions. Except to the extent that the escrow agreement expressly permits, a principal cannot sell, transfer, assign, mortgage*, enter into a derivative transaction concerning,* or otherwise deal in any way with the holder's escrow securities or any related share certificates or other evidence of the escrow securities. A private company, controlled by one or more principals of the issuer, that holds escrow securities of the issuer, *may not participate in a transaction that results in* a change of its control *or a change in the economic exposure* of the principals to the risks of holding escrow securities.

[Emphasis added.]

The term "economic exposure" in relation to a reporting issuer generally refers to the link between a person's economic or financial interests and the economic or financial interests of the reporting issuer in which the person is an insider. The term is intended to have broad application and is best illustrated by way of example.

An insider with a substantial proportion of his or her personal wealth invested in securities of his or her reporting issuer will be highly exposed to changes in the fortunes of the reporting issuer. Conversely, an insider who holds no securities of a reporting issuer (and does not participate in a compensation arrangement involving securities of the reporting issuer such as a stock option plan) will generally have significantly less exposure to the reporting issuer. The insider's exposure will generally be limited to the insider's salary and other compensation arrangements which do not involve securities of the reporting issuer.

All other things being equal, if an insider changes his or her ownership interest in a reporting issuer (either directly, through a purchase or sale of securities of the reporting issuer, or indirectly, through a derivative transaction involving securities of the reporting issuer), the insider will generally be changing his or her economic exposure to the reporting issuer. Similarly, if an insider enters into a hedging transaction which has the effect of reducing the sensitivity of the insider to changes in the reporting issuer's share price or performance, the insider will generally be changing his or her economic exposure to the reporting issuer.

3. What does "economic interest" in a security mean?

The term "economic interest in a security" is defined in the Regulation to mean

- a right to receive or the opportunity to participate in a reward, benefit or return from the security, or
- exposure to a loss or a risk of loss in respect to the security.

The term is intended to have broad application and is intended to refer to the economic attributes ordinarily associated with beneficial ownership of a security, such as the following:

- the potential for gain in the nature of interest, dividends or other forms of distributions of income on the security;
- the potential for gain in the nature of a capital gain realized on a disposition of the security, to the extent that the proceeds of disposition exceed the beneficial owner's tax cost (that is, gains associated with an appreciation in the security's value); and
- the potential for loss in the nature of a capital loss on a disposition of the security, to the extent that the proceeds of disposition are less than the beneficial owner's tax cost (that is, losses associated with a fall in the security's value).

The beneficial owner could, for example, eliminate the risk associated with a fall in the value of the securities, while retaining legal and beneficial ownership of the securities, by entering into a derivative transaction such as an equity swap. If the beneficial owner is an insider, and the securities are securities of the insider's reporting issuer, such a transaction would likely trigger the test in section 2.1 of the Regulation. (Such a transaction might also be covered by the existing insider reporting rules, depending on the particular facts and circumstances of the transaction.)

4. Why is it necessary to refer to both "economic exposure" in relation to a reporting issuer and "economic interest" in a security of the reporting issuer? How are they different?

In many cases, an arrangement which satisfies the "economic exposure" test in subparagraph 2.1(a)(ii) will also satisfy the "economic interest" test in subparagraph 2.1(a)(i). However, the tests are not identical. For example, there will be arrangements which satisfy the latter test, but not the former test, but which would nevertheless impinge upon the policy rationale for insider reporting.

For example, if an insider holds no securities of his or her reporting issuer, and enters into a short position (a "naked short"), or a synthetic arrangement that replicates a short position, in the expectation that the share price will fall, the test in s. 2.1(a)(i) may not apply, since the insider would not be altering his or her economic interest in any securities of the reporting issuer. A similar result would occur if the number of securities sold short exceeded the number of securities held. Such arrangements would appear to satisfy the policy rationale for insider reporting, and should be transparent to the market.

Secondly, the "economic interest" test may not catch certain derivative-based compensation arrangements that we believe should be subject to a disclosure requirement. If a compensation arrangement allows for an exercise of discretion similar to the exercise of discretion contemplated by a conventional stock option plan, we believe that this exercise of discretion should be transparent to the market. If the arrangement provides for a payout in the form of cash reflecting the change in value of a security, rather than a payout in the form of a security, there may be a question as to whether the arrangement involves a "security". In this case, there may be a question whether such an arrangement would be caught by the "economic interest" test.

Thirdly, the economic exposure test requires consideration of related financial positions. If an insider, for example, holds a long position and an offsetting short position, the acquisition of the short position arguably does not directly affect the insider's economic interest in the long position. Arguably the insider retains his or her economic interest in the long position (viewed in isolation). It is only through consideration of the related offsetting positions together that the insider may be said to have changed his or her economic position. The insider has neutralized his or her economic exposure to the issuer.

Although it may be argued that the "economic interest in a security" test may be subsumed within the "economic exposure" test, we believe there are advantages to retaining this test as a separate test. The economic interest test references the means by which an insider may alter his or her economic exposure to the reporting issuer. We believe that, in some cases, this test may be easier to understand, and consequently easier to apply, than the economic exposure test, since this test references the direct economic consequences of a monetization transaction. Accordingly, if an insider enters into an arrangement which has the effect, for example, of divesting the insider of the risk that certain securities owned by the insider may fall in value, and none of the exemptions in the Regulation otherwise applies, s. 2.1(a)(i) makes it clear that there is a reporting obligation. It is not necessary to then consider the issue of whether this arrangement has the effect of altering the insider's economic exposure.

An additional reason for retaining the economic interest test is that this test generally approximates the approach taken by the U.S. insider reporting requirements. Under the U.S. insider reporting requirements, insiders are generally required to report any transaction resulting in a change in "beneficial ownership" of equity securities of the issuer. For reporting purposes, a person is deemed to be the "beneficial owner" of securities if the person has a "pecuniary interest" in the securities. The term "pecuniary interest" in any class of equity securities is defined to mean "the opportunity, directly or indirectly, to profit or share in any profit derived from a transaction in the subject securities". See generally SEC Rule 16a-1(a)(2). One of the objectives underlying the adoption of the Regulation is to introduce greater consistency in the reporting requirements under U.S. securities law and Canadian securities laws in relation to monetization arrangements. Consequently, the reference to an "economic interest in a security" in the Regulation is intended to parallel the "pecuniary interest" test in the U.S., and to clarify that monetization transactions which are reportable under U.S. insider reporting requirements will also generally be covered by Canadian insider reporting law requirements, unless covered by one of the exemptions.

5. What are the exemptions to the insider reporting requirement contained in the Regulation?

The Regulation contains a number of exemptions for insider transactions which satisfy one of the tests in section 2.1 of the Regulation. These include:

- arrangements which do not involve, directly or indirectly, a security of the reporting issuer or a derivative in respect of which the underlying interest is or includes as a material component a security of the reporting issuer;

- a compensation arrangement such as a phantom stock plan, deferred share unit ("DSU") plan or stock appreciation right ("SAR") plan which would otherwise be caught by the Regulation if:

    - the existence and material terms of the compensation arrangement are disclosed in any public document (such as the annual audited financial statements of the issuer or an annual filing made under any provision of Canadian securities legislation); *or*

    - the material terms of the compensation arrangement are set out in a written document, and the alteration to economic exposure or economic interest referred to in section 2.1 occurs as a result of the satisfaction of a pre-established condition or criterion described in the document, and does not involve a discrete investment decision by the insider.

- a person or company exempt from the insider reporting requirements under an exemption contained in Canadian securities legislation (such as, for example, Regulation 55-101 respecting Insider Reporting Exemptions (Regulation 55-101) or Regulation 62-103 respecting The Early Warning System and Related Take-Over Bid and Insider Reporting Issues), to the same extent and on the same conditions as are applicable to such exemption;

- a person or company who has obtained exemptive relief in a jurisdiction from the insider reporting requirements of that jurisdiction, to the same extent and on the same conditions as are applicable to such exemptive relief;

- a transfer, pledge or encumbrance of securities by a person or company for the purpose of giving collateral for a debt made in good faith so long as there is no limitation on the recourse available against the person or company for any amount payable under such debt;

- the receipt by an insider of a transfer, pledge or encumbrance of securities of an issuer if the securities are transferred, pledged or encumbered as collateral for a debt under a written agreement and in the ordinary course of business of the insider;

- to an insider, other than an insider that is an individual, that enters into, materially amends or terminates an agreement, arrangement or understanding which is in the nature of a credit derivative;

- a person or company who does not know and could not reasonably know of the alteration to economic exposure or economic interest referred to in section 2.1; and

- the acquisition or disposition of a security of certain investment funds.

6. What does the reference to "material component" in paragraph 2.2(a) of the Regulation mean?

This is intended to ensure that if an insider entered into a derivative arrangement which satisfied one of the alteration tests in section 2.1, and in respect of which the underlying interest was a basket of securities or an index which included securities of the reporting issuer, such arrangement would trigger a reporting requirement only if the derivative involved securities of the reporting issuer "as a material component". In determining materiality, similar considerations to those involved in the concepts of material fact and material change would apply.

7. Why is there an exemption for compensation arrangements?

Many compensation arrangements are specifically adopted for the purpose of creating incentives for the directors, officers and employees who participate in such arrangements to improve their performance. Such arrangements are specifically intended to align the economic or financial interests of the recipient with the economic or financial interests of the employer. In many cases, such arrangements would likely satisfy the economic exposure test contained in section 2.1 of the Regulation.

Many compensation arrangements, such as stock option plans, phantom stock plans, deferred share unit plans and stock appreciation right plans, involve, directly or indirectly, a security of the reporting issuer or a derivative which involves a security of the reporting issuer. Consequently, the exemption in subsection 2.2(a) would likely not be available for such plans.

We have added a broad exemption in subsection 2.2(b) to address compensation arrangements, as compensation arrangements are not the primary focus of the Regulation. In most cases, we do not expect there to be any change to the existing approach to reporting (or not reporting) such compensation arrangements.

A compensation arrangement will only be caught by the Regulation if:

- the insider "is not otherwise required to file an insider report in respect of such ... arrangement ... under any provision of Canadian securities legislation"; (see s. 2.1(b))

- the arrangement "... involve[s], directly or indirectly, a security of the reporting issuer or a derivative in respect of which the underlying interest is or includes as a material component a security of the reporting issuer"; (see 2.2(a))

- the arrangement is not disclosed in any public document (such as audited annual financial statements or any other regulatory filing); and (see 2.2(b)(i))

- the insider is able to alter his or her economic interest in securities of the reporting issuer, or his or her economic exposure to the reporting issuer, through discrete investment decisions. (see 2.2(b)(ii))

We believe that most compensation arrangements will be excluded on several grounds. To the extent a compensation arrangement is not excluded on any of these grounds, we believe that there is a compelling case for public disclosure of such arrangement.

Subparagraph 2.2(b)(i) provides an exemption for a compensation arrangement which is required to be disclosed, or is disclosed, in a public document such as audited annual financial statements or another form of regulatory filing. For example, an issuer may establish a deferred share unit (DSU) plan with a view to enhancing the alignment of the interests of its directors with those of its shareholders. Assuming that the DSU plan is not otherwise covered by the insider reporting requirements under Canadian securities legislation, an insider who participated in the plan would likely be required to file insider reports as a result of the insider's participation in the plan since the plan would likely satisfy the economic exposure test contained in section 2.1 of the Regulation. However, if the DSU plan is disclosed in a public document such as a Management Proxy Circular, an insider who participated in the DSU plan would not be required to file insider reports relating to the insider's participation in the plan, since the insider would be entitled to rely on the exemption in subparagraph 2.2(b)(i).

Subparagraph 2.2(b)(ii) provides an exemption for a compensation arrangement which is not publicly disclosed, and which has the effect of altering the insider's economic exposure to the reporting issuer, or the insider's economic interest in securities of the reporting issuer, if

- the compensation arrangement is in writing,

- the alteration occurs as a result of the satisfaction of a pre-established condition or criterion (such as the insider's retirement from office or ceasing to be a director), and

- the alteration does not involve a "discrete investment decision" by the insider.

Part 5 of Regulation 55-101 provides a similar exemption from the insider reporting requirements for securities which are acquired under an "automatic securities purchase plan". Section 4.2 of Policy Statement to Regulation 55-101 respecting Insider Reporting Exemptions, similarly refers to the concept of a "discrete investment decision".

8. Why is the exemption for a pledge of securities as collateral for a good faith debt limited to a debt in which there is no limitation on recourse?

We believe that it is important to restrict the debt exemption to debts in which there is no limitation on recourse for the reason that a limitation on recourse may effectively allow the borrower to "put" the securities to the lender in satisfaction of the debt. The limitation on recourse may effectively represent a transfer of the risk that the securities may fall in value from the insider to the lender. We believe that, in these circumstances, the transaction should be transparent to the market.

A loan secured by a pledge of securities may contain a term limiting recourse against the borrower to the pledged securities (a legal limitation on recourse). Similarly, a loan secured by a pledge of securities may be structured as a limited recourse loan if the loan is made to a limited liability entity (such as a holding corporation) owned or controlled by the insider (a structural limitation on recourse). If there is a limitation on recourse as against the insider either legally or structurally, the exemption would not be available.

PART 3 OTHER INFORMATION

1. How do I complete an insider report for an arrangement covered by the Regulation?

An insider will file the same form of insider report as he or she would in the case of an ordinary purchase or sale of securities of the reporting issuer in question.

A CSA staff notice containing examples of various types of monetization arrangements, together with examples of completed forms for such arrangements, will be published on or before the date the Regulation takes effect.

2. Why does the Regulation require disclosure of certain arrangements which were entered into prior to the effective date of the Regulation?

The Regulation contemplates that, in certain circumstances, it will be necessary for insiders to disclose the existence of *pre-existing* monetization arrangements.

If an insider of a reporting issuer, prior to the effective date of the Regulation, entered into an agreement, arrangement or understanding in respect of which

- the insider would have been required to file an insider report under this Regulation if the agreement, arrangement or understanding had been entered into on or after the effective date, *and*

- the agreement, arrangement or understanding remains in effect on or after the effective date of the Regulation,

then the insider will be required to file a report under the Regulation.

We believe it is necessary for the Regulation also to address pre-existing arrangements *which continue in force after the effective date* since, if such arrangements are not disclosed, the insider reporting regime will continue to convey materially misleading information about certain insiders' true economic positions in their issuers.

For example, if an insider, *before* the Regulation comes into force, enters into a monetization arrangement which has the effect of divesting the insider of substantially all of the economic risk and return associated with the insider's securities in the reporting issuer, and the insider then files an insider report *after* the Regulation comes into force that indicates that the insider continues to have a substantial ownership position in the issuer, we believe the pre-existing arrangement will render the insider report (and all future insider reports) materially misleading. The insider report will not convey an accurate picture of the insider's true economic positions in his or her issuer.

For these reasons, we believe that it is necessary for insiders to disclose the existence of pre-existing monetization arrangements which have a continuing impact on publicly reported holdings.