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**RESEARCH IN MOTION LIMITED – OPTION GRANTING SCANDAL**



**RIM's Improper Option Backdating and Option Repricing Practices from 1996 to 2006**

Over the 10 year period from December 1996 to July 2006, James Balsillie (“Balsillie”), as Chairman of the Board and co-CEO, Mike Lazaridis (“Lazaridis”), as President and co-CEO, Dennis Kavelman (“Kavelman”), as the then CFO, the then Director of Finance, and certain members of the Board of Directors of Research in Motion Limited (“RIM”), engaged in improper stock option granting practices, including backdating and repricing of executive, director and employee stock option awards. From February 2002 to August 2006, for example, there were improper option dating practices for 321 grants on options for 4,581,000 common shares, representing 63% of the grants made by RIM after February 2002.

On May 17, 2007, RIM announced a restatement of its historical financial statements with a cumulative, non-cash stock-based compensation expense in respect of options granted between 1999 and 2006 of U.S.\$248.2 million up to the end of fiscal 2006. This restated compensation expense was charged against retained earnings (deficit).

On January 27, 2009, in a Settlement Agreement approved by the OSC, Balsillie, Lazaridis and Kavelman agreed they engaged in the grant of options in which backdating and repricing occurred and that the total “in-the-money” previously undisclosed benefit from incorrect dating practices was approximately C\$66 million. They confirmed that they returned the improper financial benefits they received from the options that were incorrectly priced, and undertook to contribute, in aggregate, C\$83.1 million to RIM and to pay administrative penalties and OSC investigation costs totalling C\$9 million.

Until August 2006, all option grants were made by or under the authority of Balsillie or his delegate, except grants to him and Lazaridis. For a number of years after the Company’s 1997 IPO, Balsillie was directly involved in approving grants, including grants that were accounted for improperly. Balsillie’s direct involvement in approving grants diminished over time as more responsibility for grants was delegated, without explicit conditions or documentation to Kavelman (who was CFO from 1997 to March 2007), and other employees. Balsillie, together with Kavelman and the then Director of Finance, and, in some cases, Lazaridis, selected favourable grant dates in which option backdating and repricing occurred. The majority of periodic grants (as opposed to new hire grants) were accounted for using incorrect measurement dates, with the result that the exercise price was less than the fair market value at the completed grant date. The option backdating and repricing resulted in more favourable or lower exercise prices, providing grantees with an “in the money” undisclosed benefit that was not recorded in the financial statements as stock-based compensation. In many instances, including grants to the co-CEOs, COOs and the CFO (“C-level officers”), hindsight was used to chose the lowest price in a period in order to set the grant date and therefore the lower exercise price, and in some cases grant dates were selected based on low prices over a future period. As options over more common shares were granted to more senior employees, such employees received a greater individual undisclosed benefit from these option granting practices. Each of the Company’s C-level officers and certain other officers and outside directors received “in-the-money” benefits from option grants made at less than fair market value as of the completed grant option process date. The total “in the money” unauthorized and undisclosed benefits for employees from these improper practices was \$66 million, of which approximately \$33 million was not reimbursed or repaid to RIM or otherwise forfeited or cancelled. (The \$33 million, plus interest of \$5.3 million, was subsequently ordered by the OSC to be contributed to RIM by Balsillie, Lazaridis and Kavelman as part of the approval of the January 27, 2009 Settlement Agreement.) Prior to fiscal 2007, RIM did not record any stock based compensation amounts in its financial statements.

These backdating and repricing practices were contrary to the clear terms of RIM’s December 1996 stock option plan and the rules of the Toronto Stock Exchange, both of which required that options were to be granted at an exercise price not lower than the market price of the common shares on the TSE on the last trading day preceding the date the grant was approved by the RIM Board<sup>1</sup>. Prior to February 27, 2002, all options granted were also incorrectly accounted for under U.S. GAAP.

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<sup>1</sup> The RIM stock option plan was amended in July 1998 to provide in section 2.05 that the “exercise price per Common Share with respect to any option shall be determined by the Board of Directors at the time the option is granted, but such price shall not be less than the closing price of the Common Shares on the Exchange on the last trading day preceding the date on which the grant of the option is approved by the Board of Directors.” From

RIM's option plan required the RIM Board to determine the exercise price, unless that authority was delegated to the Compensation Committee. There was no resolution passed by the RIM Board delegating its authority. In fact, the RIM Board minutes reflected that the RIM Board thought, incorrectly, that Balsillie had the authority, as Chairman of the Board, to grant options to all employees other than himself and Lazaridis. The only grants approved by the RIM Board or the Compensation Committee were those made to Balsillie and Lazaridis. Of the 16 stock option grants made to Balsillie and Lazaridis from December 1996 to August 2006, 12 of the grants to the co-CEOs were priced at a date prior to, or, in two instances, subsequent to Board or Compensation Committee approval.

From July 1998 to August 2006, most of RIM's public securities filings, including its financial statements, contained misleading and untrue statements that options were priced at the fair market value of its common shares at the date of grant in accordance with the terms of its option plan (53 specific misleading public filings were listed in the Settlement Agreement with the OSC). In particular, RIM's management proxy circulars for the election of directors and its prospectuses issued in 1999, 2000 and 2004 repeated these misleading or untrue statements which did not properly or accurately reflect RIM's actual option granting practices. The management proxy circulars also substantially understated the true compensation awarded to its senior executive officers, including Balsillie and Lazaridis, by failing to disclose the unauthorized additional benefits received as a result of the improperly dated options.

Every RIM annual report between 1998 and 2006 contained a statement signed by Lazaridis and Kavelman, then CFO, that RIM maintained accounting and internal controls that it believed provided reasonable assurance that transactions were executed in accordance with management's authorization and that RIM's financial records were reliable for the preparation of accurate financial statements. In its oral reasons at the February 5, 2009 Settlement Hearing, the OSC stated that, to the contrary, "the Option granting practices were characterized by informality and a lack of definitive documentation, and lacked safeguards to ensure compliance with applicable accounting, regulatory, and disclosure rules", and that "Balsillie, Lazaridis and Kavelman all certified various filings containing misleading or untrue disclosure."

### **Summary of Events Arising from RIM's Improper Option Pricing Practices**

1. August 8, 2006: RIM commenced a voluntary internal review of its option granting practices and related accounting. Commentary on the Board members who undertook this internal review is set out in the sub-paragraphs immediately below:
  - The internal review was commenced under the direction of the Audit Committee composed of non-management directors Dr. Douglas Wright, Kendall Cork, James Estill and John Richardson. Dr. Douglas Wright and Kendall Cork subsequently recused themselves from the Audit Committee review on or about January 16, 2007 because the two of them constituted and were the only members of RIM's Compensation Committee. The internal review with respect to RIM's option granting practices was completed by the other members of the Audit

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December 1996, when the RIM stock option plan was adopted by the Board, to July 1998 when it was amended as above, section 2.05 had a similar requirement. The TSE Company Manual, which RIM was required to comply with when it became a TSE listed issuer in December 1997, contained similar provisions.

Committee, James Estill and John Richardson (the “Special Committee”), on or about March 2, 2007. The related accounting issues and restatement of RIM’s financial statements arising out of the internal review of the improper option granting practices were not finalized until on or about May 17, 2007.

- James Estill, one of the two members of the Special Committee, was a respondent in the January 27, 2009 Settlement Agreement with the staff of the OSC. He was ‘reprimanded’ by the OSC and subject to the orders of the OSC that approved the Settlement Agreement, as referred to below. Estill had been a director of RIM since 1997 and a member of the Audit Committee from 1998 through 2007.
  - Estill was re-nominated for election as a RIM director by the Board subsequent to the February 2009 OSC hearing and sanctions order and elected as a director at RIM’s AGMs in July 2009 and again in July 2010. He then served on the Board’s Oversight Committee and its Compensation, Nomination & Governance Committee.
  - At the July 14, 2009 RIM AGM, 7.52% of the votes were “withheld” against the election of Estill, and 5.75% were “withheld” against his election at the July 13, 2010 AGM. Estill was not nominated for election as a director for the July 2011 AGM.
- When the Special Committee issued its March 5, 2007 report of its findings on RIM’s stock option granting practices, both Dr. Douglas Wright and Kendal Cork then advised that they would not stand for re-election and tendered their resignations at that time from all committees of RIM’s Board.
  - Dr. Wright, President Emeritus of the University of Waterloo and a RIM director since 1995, was a member of the Audit Committee since 1996 and its Chair from 1998; a member of the Compensation Committee from 1998 and its Chair from at least 2003; and a member of the Nominating Committee.
  - Mr. Cork, a director since 1998, was a member of the Audit Committee since 1999; and a member of the Compensation Committee since 2000.
  - The March 5, 2007 Special Committee report said that Dr. Wright and Mr. Cork “*will each be appointed* to the honorary position of Director Emeritus of the Board in recognition of their substantial contributions to RIM over many years.” [emphasis added]
  - On June 14, 2007, the RIM Board approved an amendment to its Stock Option Plan to allow that options, including unvested options, held by directors did not terminate upon the director ceasing to be a director, as they otherwise would, if such person is appointed a Director Emeritus of the Company.

- Effective July 17, 2007, Dr. Wright and Mr. Cork were each appointed by RIM to the honorary position of Director Emeritus “in recognition of their substantial contributions to the Company over many years.”
  - The amendment allowed the options held by each of Dr. Wright and Mr. Cork, as former directors, to continue to be subject to their original terms after they ceased to be directors, and the additional compensation expense was estimated by RIM to be approximately \$2 million.
  - At the July 17, 2007 RIM Annual Meeting of Shareholders, shareholders voted 64.11% for and 35.89% against the amendments to the Stock Option Plan.
  - For the two fiscal years ended March 1, 2008, RIM paid legal fees totalling \$581,785 for the law firms acting for both Dr. Wright and Mr. Cork in connection with the stock option investigations under indemnity agreements between them and RIM and its by-laws.
- Subsequently, in the January 27, 2009 Settlement Agreement with the staff of the OSC referred to below, each of Dr. Douglas Wright, Kendall Cork and James Estill undertook to the OSC that he had repaid to RIM any increased benefit he received from the allocation to him of incorrectly priced stock options, and was, by order of the OSC, ‘reprimanded’ by the Commission, and also ordered to complete an acceptable course regarding the duties of directors and officers of public companies within 12 months.
2. September 28, 2006: RIM announced that accounting errors were made under U.S. GAAP in connection with the accounting of certain stock options grants since RIM’s initial public offering in 1997 and that a restatement of RIM’s historical financial statements would be required.
  3. October 13, 2006: RIM announced it would delay the release of its quarterly financial statements and related MD&A for the three months ended September 2, 2006 (the second quarter of fiscal 2007) due to be filed by October 17, 2006.
  4. November 7, 2006: When RIM did not file its quarterly financial statements by October 17, the OSC issued a temporary cease trading order against RIM’s directors and senior officers with respect to the Company’s securities and, following a hearing on November 7, 2006, the OSC issued a management cease trading order (“MCTO”).
  5. November 30, 2006: The OSC amended its MCTO to permit Balsillie and Lazaridis to exercise stock options issued on December 4, 1996, when RIM became a reporting issuer, and which expired December 4, 2006. Balsillie was permitted to exercise options on 245,000 shares and Lazaridis on 500,000 shares, in each case at an exercise price of \$1.70 per share (pre 3-for 1 split). The shares issued on exercise of the options were

ordered to be placed in escrow pending completion of the review of RIM's historical option granting practices.

6. When RIM announced that it would not file its restated financials and interim financials for the second and third quarters of fiscal 2007 until its fiscal year end of March 3, 2007, the OSC extended the MCTO. The MCTO remained in effect from November 7, 2006 until May 23, 2007.
7. March 2, 2007: Balsillie voluntarily resigned as Chairman of the Board. John Richardson, an independent director appointed to the Board in 2003 and a former senior partner in Clarkson Gordon & Co., a predecessor firm of RIM's auditor, Ernst & Young LLP, was designated as Lead Director of the Board. The CFO, Kavelman, and the former Director of Finance also stepped down from those positions and any financial reporting function and moved to the operations side of RIM's business.
8. March 5, 2007: RIM issued the results of its Special Committee internal review of its stock option grant practices and accounting errors in connection with the administration of certain stock option grants after reviewing 3,231 stock option grants made between December 1996 and August 2006 to 2,034 RIM officers, directors and employees. The report stated that the accounting impact of the findings from the internal review were then not completed and that the restatements for its historical financials for fiscal 2004, 2005 and 2006 and the first quarter of 2007 (statements for the second and third quarters of 2007 had not then been filed) were not yet available. The report of the Special Committee did state that the result of the restatements will be to increase the amount of non-cash compensation expense (then estimated at U.S.\$250 million) and thereby reduce previously reported earnings. The report also commented, among other things, that:
  - Balsillie and Kavelman "reported that at the time they had a general understanding that options could be granted at a chosen date within the applicable period for reporting option grants to relevant Canadian regulatory agencies. Their understanding was incorrect." RIM's granting practices "deviated from the authorization requirements as set out in the Stock Option Plan."
    - The terms of the Stock Option Plan provided that options be approved by the Board or the Compensation Committee and that options be granted at an exercise price not less than the closing price on the TSE or NASDAQ on the last trading day preceding the date on which the grant was approved.
    - Balsillie, a RIM director since 1993 and Co-CEO, has a Bachelor of Commerce (Honours Economics) degree from University of Toronto (Trinity College), a chartered accountant designation with the ICAO and CICA, an MBA from Harvard Business School, and an FCA from the ICAO. Balsillie held various prior senior positions in the Strategy Consulting Group and the Entrepreneurial Services Group at Ernst & Young LLP, RIM's external auditors. Balsillie oversaw Board responsibility, strategy and business development at RIM.

- Kavelman has a BBA (Honours) degree from Wilfred Laurier University in Waterloo, a chartered accountant designation from the ICAO and the CICA, and finished first in Canada in the Chartered Accountant Uniform Final Examination. Before joining RIM in 1995, he was a Corporate Finance Specialist with KPMG. Kavelman was then responsible for finance, accounting and treasury management.
- “[T]he Company failed to maintain adequate internal and accounting controls with respect to the issuance of options in compliance with the Company’s stock option plan, both in terms of how options were granted and documented, and the measurement date used to account for certain option grants. The grant process was characterized by informality and a lack of definitive documentation, and lacked safeguards to ensure compliance with applicable accounting, regulatory and disclosure rules.”
  - The Special Committee said it did not find intentional misconduct on the part of those responsible for the administration of the Stock Option Plan.
  - All directors and all C-level officers agreed to return any benefit on previously exercised options and to re-price unexercised options that were incorrectly priced, in both cases to the price that should have been used.
9. March 5, 2007: The Special Committee report of RIM’s internal review also reported a number of corporate governance changes at RIM, including:
- “Consistent with current best practices in corporate governance, *the roles of Chairman and CEO are being separated*. Mr. Balsillie has voluntarily stepped down from the role Chairman to allow future consideration of a non-executive Chairman by the Nominating Committee. Mr. Balsillie will retain his leadership roles as Co-CEO and Director.” [emphasis added]
  - Dr. Douglas Wright and Kendal Cork advised that they would not stand for re-election and immediately resigned from all Board committees. The March 5 Special Committee report said that they “*will each be appointed* to the honorary position of Director Emeritus of the Board in recognition of their substantial contributions to RIM over many years.” [emphasis added]
  - RIM will establish an internal audit department to report to the Audit Committee.
  - “The Board, based on the recommendation of the Special Committee, has determined that no employees should be asked to leave the Company as a result of the Review.”
10. May 17, 2007: As a result of its continuing internal review of its option granting practices and various accounting errors, RIM announced a restatement of its previously filed U.S. GAAP financial statements. As a result, RIM took a cumulative, non-cash stock-based compensation expense for options granted between 1999 and 2006 of

U.S.\$248.2 million. The restatement resulted from granting “in the money” options, as well as the misapplication of U.S. GAAP relating to a “net settlement” provision in RIM’s option plan through fiscal 2002.

11. May 17, 2007: RIM’s announcement concerning RIM’s restatement of its financial statements also included the following:
  - RIM stated that “*the roles of Chairman and CEO have been separated*”. Balsillie resigned as Chairman “to allow future consideration of a non-executive Chairman by the Nominating Committee.” Balsillie remained co-CEO and a director; [emphasis added]
  - The Board size was increased for seven to nine and two outside independent directors were appointed to the Board;
  - Two new additional outside independent directors were to be identified to replace Dr Douglas Wright and Kendall Cork;
  - Kavelman moved from CFO to the position of COO and a new Chief Accounting Officer was appointed as RIM’s senior financial officer;
  - RIM said it was in the process of establishing an internal audit department.
12. July 2007: The Compensation Committee of RIM granted a bonus of U.S.\$1,130,151 to each of Balsillie and Lazaridis in recognition of their work in the fiscal period ended March 3, 2007. (These bonuses for fiscal 2007 were not disclosed in the management information circular for the July 17, 2007 AGM as RIM stated that they were determined after the date of the circular for that meeting of shareholders. These bonuses were disclosed in the May 28, 2008 proxy circular for the July 15, 2008 AGM.)
13. March 2008: For the fiscal year ended March 1, 2008, the annual base salary of each of Balsillie and Lazaridis was increased from U.S.\$549,250 to U.S.\$1,119,952; they each received a bonus of U.S.\$1,727,281; and they each were granted options on 200,000 RIM common shares.
14. January 27, 2009: Following an investigation by the OSC into RIM’s option granting practices, RIM, Balsillie, Lazaridis, Kavelman and another executive officer and certain RIM directors (including former directors Kendall Cork and Dr. Douglas Wright, and then current director James Estill) entered in to a Settlement Agreement with the staff of the OSC (referred to below). Staff of the OSC did not allege that RIM management acted fraudulently in issuing options or in making misrepresentations in its public disclosures describing its option granting practices. The allegation was that “there was negligence and a lack of due care over an extended period of time”, and that they “breached Ontario securities law and/or have acted contrary to the public interest.”
15. February 2009: As required by the Settlement Agreement, Balsillie was forced to resign as a director of RIM. Balsillie also undertook not to act as a director of any reporting



issuer until the later of (a) 12 months from the date of the OSC order approving the Settlement Agreement, and (b) RIM's compliance with the OSC's requirement to undergo an independent governance assessment by an outside consultant. (Balsillie was re-appointed a RIM Director by its Board on May 28, 2010 and was subsequently elected by the Board to the new office of Co-Chair with Lazaridis in December 2010.)

### **OSC Settlement Hearing and Sanctions for RIM's Improper Options Granting Practices**

On February 5, 2009, the OSC held a hearing to consider whether to approve the Settlement Agreement. In its public record, the OSC stated it considered "the misconduct here to have been extremely serious". It expressed its concerns with RIM's governance practices and its backdating and repricing of options in part as follows:

"We consider it shocking that this misconduct occurred over a ten-year period. It meant that there were undisclosed benefits being given to directors, officers and employees and misleading or untrue disclosure being made over that period. In addition to the direct involvement of Balsillie, Kavelman, Lazaridis and Loberto [former Director Finance] in these practices, *there was a fundamental failure of governance, a failure by the Board of Directors of RIM to carry out appropriately its oversight responsibilities*, both in terms of compliance with the Option Plan and the rules contained in the TSX Company Manual (the "TSX Rules"), but more fundamentally in failing to provide appropriate oversight with respect to the issue of securities and compliance with securities laws." [emphasis added]

"Balsillie, as Chairman of the Board and co-Chief Executive Officer, Lazaridis, as President and co-Chief Executive Officer, Kavelman as CFO and Estill, Cork, Wright and Fregin as directors, failed to exercise reasonable diligence to ensure that RIM prepared disclosure documents containing disclosure that was not misleading or untrue or contrary to the Act. ..."

The OSC approved the Settlement Agreement, which included undertakings from the individual respondents, and ordered sanctions against Balsillie, Lazaridis and Kavelman:

- (a) Balsillie undertook not to act as a director of any public company until the later of 12 months from the OSC's order and RIM's compliance with the independent Governance Assessment (referred to below);
- (b) Balsillie, Lazaridis and Kavelman undertook to contribute \$38.3 million (which included \$5.3 million of interest) to RIM for the outstanding benefits to employees for improperly priced option awards that had not been reimbursed;
- (c) Balsillie, Lazaridis and Kavelman undertook to contribute \$44.8 million to RIM to defray its costs in the investigation and remediation of its improper option granting practices. (\$15 million had previously been paid by Balsillie and Lazaridis for costs incurred);
- (d) Balsillie was 'reprimanded' by the OSC and ordered to pay an administrative penalty of \$5 million and \$700,00 to the OSC for investigation costs;

- (e) Lazaridis was ‘reprimanded’ by the OSC and ordered to pay an administrative penalty of \$1.5 million and \$150,000 to the OSC for investigation costs;
- (f) Lazaridis undertook to take a course on the duties of directors and officers of public companies within 12 months;
- (g) Kavelman was prohibited from acting as a director or officer of any reporting issuer until the later of 5 years from the OSC’s order and the date he completed a course on the duties of directors and officers of public companies;
- (h) Kavelman was ‘reprimanded’ by the OSC and ordered to pay an administrative penalty of \$1.5 million and \$150,00 to the OSC for investigation costs.

The OSC order approving the Settlement Agreement provided that the individual respondents could not be indemnified by RIM “for any of the payments associated with or paid by the Individual Respondents as a result of this settlement and this order.”

RIM paid legal fees to law firms that had been retained by Balsillie, Lazaridis and Kavelman of U.S.\$12.3 million during RIM’s four fiscal years 2007-2010 in connection with the stock option investigations and related matters. These payments for legal fees were made under indemnity agreements between such individuals and RIM and RIM’s by-laws.

### **OSC Mandated Independent Corporate Governance Assessment of RIM**

As part of its sanctions order against RIM, Balsillie, Lazaridis, Kavelman and the others, the OSC required RIM to submit to a comprehensive review of its corporate governance practices and procedures and internal controls over financial reporting by an independent party, Protiviti Co. (the scope of the review is detailed in Schedule “C” of the Settlement Agreement). Among other matters, the OSC order required Protiviti to have access to all of RIM’s books and records and all of RIM’s directors, officers, employees and advisors, subject to lawyer-client or other legal privileges. In its final report, Protiviti disclosed limitations and restrictions on the scope of its limited review arising from RIM’s exercise of privilege and that it was not able to consider fully all items in the Settlement Agreement. Minutes and materials were heavily redacted, materials were first vetted by internal and external counsel and made available for viewing only at RIM’s or counsel’s premises with no copies for file retention or subsequent reference or review, with few exceptions. Protiviti’s report stated that after requesting additional interviews with five RIM managers to validate findings subsequent to its interviews with directors and senior officers, one such interview was granted.

The results of the Protiviti assessment and review of RIM’s governance practices as of June 30, 2009, RIM’s response to the Protiviti report and subsequent developments in respect of RIM’s corporate governance policies and practices will be the subject of a separate commentary.

### **References**

RIM public filings.

Statement of Allegations of the Staff of the Ontario Securities Commission dated February 3, 2009 *In the Matter of Research in Motion Limited, James Balsillie, Mike Lazaridis, et al.*, [http://www.osc.gov.on.ca/en/Proceedings\\_soa\\_20090203\\_rim.htm](http://www.osc.gov.on.ca/en/Proceedings_soa_20090203_rim.htm) .

Settlement Agreement dated 27 January 2009 with the Ontario Securities Commission with respect to *In the Matter of Research in Motion Limited, James Balsillie, Mike Lazaridis, et al.* [http://www.osc.gov.on.ca/documents/en/Proceedings-SET/set\\_20090127\\_rim.pdf](http://www.osc.gov.on.ca/documents/en/Proceedings-SET/set_20090127_rim.pdf) .

Settlement Hearing at the Ontario Securities Commission held February 5, 2009 and Oral Ruling and Reasons with respect to *In the Matter of Research in Motion Limited, James Balsillie, Mike Lazaridis et al.*, (2009), 32 OSCB 4434 (May 29, 2009).

Protiviti Co., “*Governance Review of Research in Motion*” (as of June 30, 2009). [http://www.osc.gov.on.ca/documents/en/Proceedings-OTH/gov\\_rev\\_20090630\\_rim.pdf](http://www.osc.gov.on.ca/documents/en/Proceedings-OTH/gov_rev_20090630_rim.pdf) .