



THE 2007
LEXPERT® / AMERICAN LAWYER
GUIDE TO THE
LEADING 500 LAWYERS
IN CANADA

5000

9th Edition

NAVIGANT
CONSULTING

Cole & Partners

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EXECUTIVE COMPENSATION

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Canadian companies are in the midst of significant changes to their executive compensation regimes. These changes are the result of increased shareholder focus and activism, particularly in the light of recent U.S. option and compensation scandals. Boards of directors and compensation committees are closely examining their processes for setting compensation and are changing the types of compensation provided to the executive team.

Companies are establishing multifaceted compensation plans that combine whole share and leveraged awards that vest on the basis of time and performance criteria.

The increased attention by shareholders is consistent with the Toronto Stock Exchange rules, which transfer to shareholders the responsibility for assessing the appropriateness of share-based incentives issued from treasury. The attention paid to backdating and springloading options in the United States and proposed new U.S. rules for disclosure of executive compensation have increased Canadian sensitivity to these issues.

More than ever, Canadian companies need to attract, retain and motivate executives under the intense focus of shareholders.

Governance Process

Audit committees of boards of directors have been the focus of shareholder scrutiny. In Canada, changes to audit committee composition and processes have resulted from the northward migration of the governance principles established by the *Sarbanes-Oxley Act of 2002* and from the adoption of principles established by groups such as the Ontario Teachers' Pension Plan and the Canadian Coalition for Good Governance. As audit committees establish proper processes, ensure that their members have appropriate expertise and spend the time required to carry out their functions responsibly, the spotlight has moved to the compensation committee.

The three primary focuses on compensation processes relate to proper process, the economics of awards and disclosure.

Compensation committees are ensuring that the expert advice they receive is independent. In particular, committees now usually directly retain experts and require them to report directly to the committee. It is generally accepted that a consulting firm that does material audit or actuarial work for the company and has a strong relationship with and economic dependence on the executive team often cannot provide independent advice to the committee. Increasingly, committees will retain independent legal advice in addition to or in lieu of a consulting firm. Committees understand that market practice information may be useful, but it must be understood in the proper business and legal context.

Committees are considering the economics of the compensation package in a number of different business, financial and legal scenarios. This consideration includes financial modeling of incentive payouts using different financial assumptions. Committees are particularly concerned about avoiding incentives that provide upside only to the executive, and ensuring that large payouts are not made when results are poor or when an underperforming executive is terminated.

Committees carefully review the advice they receive and ask questions to ensure that they understand the awards being proposed. It has become common practice for the legal and compensation consultants to attend committee meetings and respond directly to questions.

Forms of Share-Based Incentive Compensation

An executive compensation package is usually composed of short-term, midterm and long-term components. The short-term component is focused on annual performance and usually consists of salary and annual cash bonuses that are paid out on the basis of the achievement of measurable annual targets. The midterm component is focused on performance over the one- to three-year period and is commonly in the form of cash, shares or restricted share units. The long-term component is focused on performance over more than three years and is often in the form of options, deferred share units or shares.

A proper compensation plan provides awards that create balanced incentives to

achieve annual, midterm and long-term corporate goals.

In response to shareholder pressure, companies have reduced the role of leveraged compensation such as options and share appreciation rights, and have increased focus on whole share compensation such as restricted share units and performance share units. Leveraged compensation rewards executives for an increase in value of the company's shares and is perceived as being "upside only"—that is, the executive does not exercise options if the share value decreases. Whole share compensation increases and decreases in value in direct relationship with changes in share value. Whole share compensation, unlike options, continues to provide an incentive even when share value decreases since the grant date.

Understanding the changes in share-based incentive compensation requires an understanding of the essential elements of these awards.

An option is the right to purchase a share for a price (the exercise price) fixed at the time of the grant of the option. When the share value exceeds the exercise price, the option is "in-the-money." When the share value is less than the exercise price, the option is "underwater." The real value of an option is that the holder can benefit from the increase in value of a share without investing until exercising the option; that is why options are perceived as having upside only. Shareholders have criticized the use of options because they may motivate volatile increases in the share prices rather than consistent growth in value, and because they lose any incentive value when significantly underwater. Moreover, executives may not place as high a value on options as the company's financial statements reflect.

Options are taxed in Canada in a way that is generally more advantageous to the holder than whole share compensation. It is primarily for this reason that options will likely remain a component of many Canadian incentive plans unless the *Income Tax Act* (Canada) (ITA) is amended.

An option may be granted with a tandem share appreciation right (SAR), which entitles the holder to a payment of the in-the-money amount, as if the holder had exercised the option, paid the exer-

cise price and immediately sold the underlying shares. SARs are generally tax advantageous to both the holder and the company. However, their accounting treatment may make them unattractive.

Restricted share unit (RSU) plans were introduced in Canada a number of years ago, apparently in response to the shift in the United States to restricted stock as compensation. Canadian tax rules are not the same as those in the United States, which permit deferred taxation of restricted stock; so in Canada, RSUs have generally been squeezed into a three-year bonus exception to salary-deferred rules under ITA. A classic RSU converts bonus compensation into a number of RSUs, determined by dividing the amount of the bonus by the value of a share at the date of grant.

RSUs can be redeemed in the form of shares issued from treasury, shares purchased on the market or cash. On redeeming an RSU, the executive will receive one share for each RSU or a cash payment determined by multiplying the number of RSUs by the fair market value of the shares on the redemption date. The value of the grant increases or decreases directly with changes in the value of shares.

Since most RSU plans are designed to fit within the three-year bonus exception, they are designed to be redeemed and taxed within three years of the year in which they were granted. This makes them suitable as a midterm incentive. However, as the pressure to provide whole share compensation increases, companies will look for share-based compensation that permits a longer tax deferral.

On redeeming RSUs, the participant is taxed on the entire value of the benefit received, on a regular employment-income basis.

A performance share unit (PSU) plan is a form of restricted share unit that requires the achievement of performance targets for the award to be redeemed. Common performance targets include earnings per share or EBITDA. Business-specific targets, such as operating without any worker injuries or properly planning for executive succession, can also be set, to allow PSUs to motivate specific behavior in addition to increasing share value.

A deferred share unit (DSU) functions economically in the same way as an RSU but is designed to come within a regulation under the ITA that allows taxation to be deferred until the DSU is redeemed. The regulation requires, among other things, that the participant not be permitted to redeem the DSU until retirement or death or the person ceases to hold office or employment. This requirement makes a DSU suitable only for long-term compensation. Furthermore, DSUs are generally unsuited to executives or to cyclical industries because they may motivate the executive team to resign in order to realize on the award. Accordingly, DSUs are more commonly awarded to directors.

On redeeming DSUs, the participant is taxed on the entire value of the benefit received, whether in cash or shares, on a regular employment-income basis.

Share grants are becoming more common and may be granted subject to restrictions, similar to U.S. restricted stock. However, in Canada share grants are fully taxed on a regular employment-income basis at the time of grant. Future increases in value are generally eligible for taxation at capital gains rates, which can make this an attractive form of compensation for high-growth companies.

Increasingly, companies require executives to achieve specified levels of share ownership. Generally all whole share awards, such as RSUs, are included in determining whether share ownership requirements are met. Some companies tie awards of leveraged share-based compensation to shares purchased by the executive—for example, ten options will be granted for each two shares purchased by the executive.

Income funds are a good example of the development of an incentive plan with a particular business focus. An income fund is designed to maximize distributions to unitholders, rather than increase the value of the units. A long-term incentive plan rewards executives who achieve this by creating a fund that is generally a percentage of the fund distributions in excess of the target distributions. That pool is divided among executives and usually vests over time to encourage executive retention. In many cases, the award is actually or notionally invested in units during the

period of deferred vesting as an additional incentive to maximize distributions and to maintain the value of the units.

New Approaches to Compensation

Many companies have introduced specific performance features to their share-based incentive plans. Common performance features include these:

- The achievement of performance targets such as EBITDA, earnings per share or revenue is required for the award to vest.
- The exercise price of the option increases over time, at a specific rate, at the rate of inflation or in accordance with peer group share prices to ensure that the option has value only if the shares outperform the appropriate metric.
- An award will only be made if target performance is achieved.

The single biggest change to compensation plans is the multifaceted approach. Companies are combining awards with performance features and time-based vesting, and are combining whole share and leveraged share awards. These multifaceted compensation arrangements are specifically designed to reward short-term, midterm and long-term performance goals. Although this increases the complexity of compensation arrangements, it tends to generate more predictable performance-based awards. For example, a new form of CEO compensation plan might provide for

- salary equal to 20% of total compensation;
- annual cash bonus equal to 20% of total compensation at target, awarded on the achievement of annual corporate objectives, with the bonus increasing by up to 50% for performance significantly in excess of target objectives;
- restricted share units that vest one-third per year for three years, equal to 15% of total compensation;
- performance share units that vest on the achievement of EBITDA targets for three years;
- time-vesting options that vest 25% on the fifth through eighth anniversaries of the grant, equal to 15% of total compensation; or

- performance options that vest over time with an exercise price that increases annually in accordance with the TSX index, equal to 15% of total compensation.

A sensible compensation plan takes into account the financial position of the company—in particular, whether it is in the best interests of the company to pay for performance by laying out cash or by diluting shareholders' interests. The executive's tax liability is also relevant because the executive will focus on the after-tax value of the award.

New TSX Practice for Amending Share Compensation Plans

Effective June 30, 2007, securityholder approval will be required for all amendments to share-based compensation plans, even those of a housekeeping or an administrative nature, unless the company has a specific, shareholder-approved amendment provision.

When the TSX rules were amended in 2005 to transfer approval of almost all aspects of share-based compensation plans to securityholders, most plans included only a general amendment provision that made amendments subject to regulatory and securityholder approval, where required. Although these general amendment provisions were inadequate under the new TSX rules, the TSX provided administrative relief through a staff notice. The staff notice identified the circumstances in which listed companies could—and could not—rely on the general amendment provisions to amend the plans without securityholder approval. Quite surprisingly, the TSX has given notice that it would retract this administrative relief effective June 30, 2007.

After June 30, 2007, TSX-listed companies must include a detailed amendment provision for their existing share-based compensation plans in order to avoid having to obtain securityholder approval for every amendment. The amendment provision must be approved by securityholders. The detailed amendment provision should specify the kinds of amendments that the board of directors (or its designate) will be permitted to make without securityholder approval and those that will require securityholder approval. We expect that most companies will want to have the power to make

housekeeping changes, accelerate vesting, effect early expiration and add cashless exercise features without securityholder approval. Companies may seek broader amending powers, although this will likely meet resistance from Institutional Shareholder Services (Canada), the Canadian Coalition for Good Governance and other securityholders. Under the TSX rules, repricing of insiders' options cannot be effected without specific securityholder approval to the repricing.

One of the other changes to the TSX rules in 2005 was to require disinterested securityholder approval to extend the term of options held by insiders. The TSX has now recognized that this rule unintentionally penalizes officers, directors and employees who, under the companies' trading policies, are prohibited from exercising options during blackout periods. To remove this unintended penalty, the TSX has confirmed that it will permit listed companies to seek securityholder approval to issue options with, or to amend outstanding options to have, a conditional expiration date. Plans may provide that the term of an option expires on a fixed date or if that expiry date occurs within a blackout period, the option expires shortly after the end of the blackout period.

We expect that during the 2007 annual general meeting season, most companies will amend their share-based compensation plans to provide for a specific power of amendment and for the extension of options that would expire during a blackout period.

Backdating and Springloading of Options

Recently, the U.S. press and securities regulators have become concerned about backdating and springloading of option grants. Backdating refers to dating the grant of an option to a time prior to the actual grant date, when the market price of the underlying share was lower than the current market price. Springloading is the granting of an option when the board has material undisclosed information that it believes will increase the market price of the underlying shares. Both backdating and springloading options are designed to achieve the same result—namely, granting an option that is already in-the-money (the exercise price exceeds the grant price)

on the grant date.

This practice is under fire in the United States because companies have not been properly disclosing the grants. Neither backdating nor springloading options are illegal per se in the United States, although both may reflect poor governance. The U.S. Securities and Exchange Commission is proposing to require specific disclosure of backdated options and may also issue guidance regarding when it is appropriate for companies to springload option grants. In addition, a number of large pension funds have commenced class action lawsuits against companies that have backdated options. These lawsuits are targeting directors on the basis that they have breached their fiduciary duty to shareholders.

The situation in Canada is quite different. Both backdating options (to take advantage of a lower market value of shares) and granting options when the board has material undisclosed information are prohibited. The TSX Company Manual expressly requires that the exercise price of an option not be lower than the fair market value on the grant date of the option. This rule applies notwithstanding shareholder approval. The TSX Company Manual also prohibits setting option exercise prices on the basis of market prices that do not reflect material undisclosed information. Further, to attract the equivalent of capital gains rate tax on the exercise of an option, the option must have an exercise price of not less than fair market value on the date of grant.

Given the existing prohibitions, we would not expect backdating or springloading of options to become significant issues for Canadian companies. On this topic, Canada appears to be well ahead of the United States.

New U.S. Executive Compensation Disclosure Rules

The SEC has proposed new disclosure rules for executive and director compensation in response to investors' calls for more transparent disclosure. The SEC believes that the current rules are out of date and manipulable, and its overriding objective is to ensure that companies provide clearer and more thorough disclosure.

The SEC's proposals apply only to U.S. domestic companies, not to Canadian or other foreign private issuers that file annual reports with the SEC on Form 20-F or

Employment Law

RECENT DEVELOPMENTS OF IMPORTANCE

Form 40-F. However, because Canada's executive compensation disclosure rules are nearly identical to the current U.S. rules, we expect Canadian regulators to study the SEC's proposals carefully, possibly with a view to importing some or all of the changes into Canada.

The major proposed changes are the following:

- The summary compensation table would contain a column for total compensation (including the dollar value of stock, option and similar incentive awards, based on their fair value on the date of grant and calcu-

lated the same way as now required under U.S. GAAP for expensing stock options).

- A "named executive officer" (NEO) would be determined by total compensation, rather than just salary and bonus.
- In addition to the disclosure of total compensation for the CEO, the CFO and three other NEOs, total compensation would now also have to be disclosed for up to three other employees, identified by job description only, whose compensation exceeds that of any NEO. These

could include any highly paid employees, such as traders, salespeople, entertainers and athletes.

- A new "compensation discussion and analysis" would have to answer specific questions that explain the company's policies and decisions about executive compensation—in nonboilerplate language and in plain English (that is, expect close scrutiny by the SEC).

We expect that Canadian executive compensation disclosure requirements will similarly expand in the relatively near future. ■



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Head of Torys' Pension and Employment Group. Practices in the areas of executive arrangements, incentive compensation and compensation governance as well as in pensions, benefits and employment. Provides advice to pension fund trustees and administrators on their pension, tax and fiduciary obligations; on governance, fiduciary and pension surplus issues; and on plan administration, conversion and windup. Practice includes all aspects of pension, benefits and employment issues in the context of mergers, acquisitions, reorganizations and outsourcing. A significant part of her practice involves the implementation of executive contracts, change-of-control agreements and retention arrangements for senior management. Advises compensation committees and boards on public company disclosure requirements; on governance obligations concerning executive compensation; and on the establishment and implementation of incentive compensation arrangements, including stock option, phantom stock, share appreciation rights, deferred share unit plans, pension plans and supplementary retirement plans. Speaks and writes regularly on pension and employment issues.