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New Rules for Executive Compensation Disclosure

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Canadian securities regulators have published final rules on executive compensation disclosure, making very few changes to their February 2008 proposals. The regulators believe that these new rules will result in better communication of what boards of directors intend to pay executives, and will also allow investors to assess how decisions about executive compensation are made. The new rules are similar – but not identical – to the SEC’s rules on executive compensation disclosure that came into effect last year.

Transition

The new rules will apply to executive compensation disclosure in respect of financial years ending on or after December 31, 2008. A company is not required to restate, for comparative purposes, disclosure for prior financial years.

To comply with the new rules, most companies will have to undertake a significant amount of work, involving legal, accounting and human resource advisers. Companies should therefore get an early start on their 2009 proxy disclosure, leaving ample time for review, feedback and comments.

Highlights

- The summary compensation table will disclose total compensation, including the dollar value of share and option awards (based on grant date fair value), non-equity incentive plan compensation and pension compensation amounts.
- The identity of the “named executive officers” (NEOs) will be based on total compensation (excluding pensions) rather than just salary and bonus. Severance and other payments resulting from termination of employment are excluded from the calculation but other one-time compensation amounts (such as signing bonuses or equity replacement awards to new hires) are not.
- Retirement benefits will be quantified for each NEO under both defined benefit and defined contribution plans.
- Companies must disclose potential payments to each NEO on termination, resignation, retirement, a change of control of the company or a change in an NEO’s responsibilities.
- A new “compensation discussion and analysis” must describe all significant elements of compensation and explain the rationale for specific compensation programs and decisions.

To discuss these issues, please contact the authors.

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Objective of the Proposed Rules

The new rules require companies to disclose all direct and indirect compensation provided to the NEOs and directors, regardless of the way the compensation is structured or whether it fits into a particular column of a table.

Compensation and Discussion and Analysis

The current Report on Executive Compensation will be replaced by a “compensation discussion and analysis” (CD&A) that puts into perspective the detailed disclosure in the tables. Much like the detailed analysis in MD&A, the CD&A should disclose and analyze the significant factors underlying the company’s compensation policies and decisions. For example, if a company’s process for setting executive compensation is very simple, relying solely on board discussions without any formal objectives or criteria, this should be clear from the CD&A.

The CD&A must cover all significant aspects of NEO compensation, including

- the objectives of any compensation program or strategy;
- what the program is designed to reward;
- each element of compensation;
- why the company chooses to pay each element;
- how the company determines the amount (and, where applicable, the formula) for each element; and
- how each element of compensation and the company’s decisions about that element fit with the overall compensation objectives and affect decisions about the other elements.

Where applicable, companies must describe any new actions, decisions or policies that were made after year-end that could affect a reasonable understanding of an NEO’s reported compensation.

Compensation Benchmarks and Performance Goals

Companies will have to disclose their compensation benchmarks and explain the relevant components, including the identity of any companies included in the benchmark and selection criteria.

Performance goals will also have to be disclosed if based on objective, identifiable measures, such as the company’s stock price or earnings per share. (If goals are subjective, the company may describe them without providing specific measures.) There is an exception if disclosure would seriously prejudice the company’s interests, but in that case, disclosure will be required of the percentage of the NEO’s compensation that relates to the undisclosed information and how difficult it could be for the NEO, or how likely it will be for the company, to achieve the undisclosed goal. If any goals constitute non-GAAP financial measures, disclosure will be required of the way the company calculates the goals from its financial statements. Companies should consider these disclosure requirements in formulating goals and adopting new compensation plans.

Performance Graph

The new rules maintain the requirement that companies provide a performance graph comparing their cumulative total return over the past five years with the return of at least one broad equity market index. (Companies that have been reporting for less than one year are exempt.) The new rules also require

companies to discuss how the trend shown by the performance graph compares with the trend in executive compensation.

Option Awards

Companies will have to describe the process used to grant options to NEOs, including the role of the compensation committee and executive officers in setting or amending any option program and whether previous grants are taken into account when considering new grants.

Summary Compensation Table

The summary compensation table will remain the main vehicle for executive compensation disclosure. It will be accompanied by a narrative description of any material factors that are necessary to understand the information in the table. A new column at the end of the table will show the total compensation for each NEO. The elements of the summary compensation table will be as follows:

- salary;
- dollar amount of share awards, based on grant date fair value;
- dollar amount of option awards, based on grant date fair value;
- non-equity incentive plan compensation, which is sub-divided into annual and long-term incentives (bonuses will be reported in this column, whether discretionary or non-discretionary);
- pension value, which includes compensatory amounts for both defined benefit and defined contribution retirement plans; and
- all other compensation – for example, perquisites, tax gross-ups, premiums for certain insurance policies, payments resulting from termination, resignation, retirement or a change of control, and all other amounts that cannot be properly reported in another column.

Incentive Plan Awards

In addition to the summary compensation table, the new rules require two tables disclosing information about equity and non-equity incentive plan awards. The significant terms of all plan-based awards will have to be disclosed. The narrative may include a discussion of performance-based or other significant conditions, information on estimated future payouts for non-equity incentive plan awards (threshold, target and maximum amounts), and the closing market price on a grant date if greater than the exercise or base price.

Outstanding Option and Share Awards

This table will show all awards outstanding at year-end. For each option or similar award, the table must show the number of securities underlying unexercised options, the respective exercise or base prices and expiration dates, and the dollar value of unexercised in-the-money options. For each share award, the table must show the number that have not vested and the respective market or payout value. (To make the calculations, companies may assume that an NEO achieved the minimum performance criteria unless his or her performance for the previous year exceeded the minimum, in which case the disclosure must be based on a corresponding assumption.)

Value on Payout or Vesting of Incentive Plan Awards

This table will show the dollar value realized on the exercise of options or the vesting of share awards. This table will also show payouts on non-equity incentive plan compensation.

Retirement Plan Benefits

The new rules call for two tables related to retirement benefits: one for defined benefit plans and one for defined contribution plans. The defined benefit plans table will show, for each NEO, the number of years of credited service, the annual benefits payable at year-end and at age 65, the accrued obligation at the start of the year, the compensatory and non-compensatory amounts, and the accrued obligation at year-end. The defined contribution plans table will show, for each NEO, the accumulated value at the start of the year, the compensatory and non-compensatory amounts, and the accumulated value at the year end.

The requirements for these tables respond to the criticism that the current pension benefits table provides only general information on benefit entitlements for selected compensation levels and years of service but does not disclose the particular circumstances or entitlements of each NEO.

Termination and Change of Control Benefits

The new rules call for detailed disclosure about incremental payments or other benefits for each NEO related to the following triggering events: retirement, resignation, termination, a change of control of the company or a change in the NEO's responsibilities. Companies will have to quantify the potential payments on the assumption that the triggering event occurred at the end of the most recent fiscal year. (If the event actually occurred earlier in the year, actual payments and benefits will be disclosed rather than hypothetical payments.)

These disclosure requirements are consistent with the U.S. rules but substantially exceed current Canadian requirements and are intended to prevent investors from being surprised after the fact by the size of an NEO's severance or other payment package.

Director Compensation

The new rules call for expanded disclosure of directors' compensation. The table is similar to the summary compensation table, but requires disclosure for only one year rather than three years.

Venture Issuers

Although certain elements of the revised disclosure requirements may not be applicable to debt-only issuers or other companies that qualify as "venture issuers," the regulators declined to grant any blanket waivers from the new rules for these issuers. The regulators did, however, indicate that they are prepared to consider the merits of applications for exemptive relief on a case-by-case basis.

SEC Issuers

SEC issuers that fully comply with the U.S. executive compensation disclosure rules (without taking advantage of any accommodations for foreign private issuers) will be permitted to provide their U.S. disclosure in satisfaction of the new Canadian requirements.

Copies of the new Form 51-102F6, Statement of Executive Compensation, can be found at www.osc.gov.on.ca/Regulation/Rulemaking/Current/Part5/rule_20080918_51-102_f6.pdf 