

# A Director's Guide to EXECUTIVE COMPENSATION

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EVENTS

## Compensation Governance

### In the News and Under Review

With the economic crisis upon us and the ensuing extensive losses in shareholder wealth and retirement savings, many are taking a closer look at executive pay and performance. In fact, executive compensation is under greater scrutiny than ever before and making news headlines on a near daily basis. This month alone our headlines included reports on: the settlement by RIM executives for stock option backdating; restrictions on executive pay in Canada as is being done under the Troubled Asset Relief Program (TARP) in the U.S.; details of the bonuses that will be foregone by our bank CEOs; and, the impact of the financial market meltdown on board share ownership requirements. Against this backdrop, our securities regulators are endeavouring to develop better governance and insider reporting requirements.

This newsletter highlights some of the recent events in executive compen-

sation and the proposed changes heading our way. Understanding what's making news, along with understanding the emerging compensation governance standards is important for organizations and their executives to avoid themselves being the next headline story.

#### Compensation Governance: In the News

#### Stock Option Backdating: An Update on RIM

A Canadian executive compensation newsletter would be incomplete without a comment on Research In Motion Ltd. (RIM). With payments totalling \$77 million, RIM's executives have just settled one of the largest cases with the Ontario Securities Commission (OSC). So what happened at RIM and how could this happen to two of Canada's most prominent business

These quarterly newsletters provide practical advice and current legal comments on executive compensation and compensation governance and disclosure. These newsletters will be of interest to directors, executives, lawyers and human resources professionals.

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#### From the Editor

Executive compensation is receiving unprecedented levels of attention from the media, shareholders and institutional investors, in Canada, the U.S. and abroad. This issue comments on the hot topics in executive compensation in Canada and the U.S. I am pleased to welcome comments on the U.S. perspective from David G. Johnson, National Service Line Leader-Compensation Strategy & Design, from the Performance and Reward group at Ernst & Young LLP. — Nadine Côté LL.B.

Stay tuned this Spring for Nadine Côté's seminar on  
Executive Compensation hosted by Lexpert

Toronto: May 4, 2009 | Calgary: May 5, 2009 | Vancouver: May 6, 2009

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#### CONTENTS

Stock Option Backdating: An Update on RIM .....	1
Hot Topics in the U.S. ....	2
Pay-cut Club: Who's in, Who's out? .....	3
Plunging Stocks & Rising Stock Ownership Guidelines .....	3
Proposed New Insider Reporting Requirements .....	3
New from the OSC: Executive Director Settlements.....	3
Proposed New Corporate Governance Disclosure .....	4

hall-of-famers?

In 2006, amidst the flurry of stock option backdating scandals wreaking havoc on companies in the U.S., RIM voluntarily undertook a review of its own stock option practices. The review was conducted by a special committee of independent directors of RIM's board, with the assistance of legal and accounting advisors. The results of its review were announced in 2007. RIM reported that it had engaged in stock option backdating in grants to its employees and directors dating back to 1996. RIM explained that sometimes hindsight had been used to establish the grant date and on other occasions, it erroneously fixed the exercise price on the date the

decision to make the grant was made. As a result, RIM had to restate its financial statements, which cut its historical profit by US\$250 million.<sup>1</sup>

RIM informed the OSC and the Securities Exchange Commission (SEC) of its findings and cooperated with the regulators in their review of its practices. RIM and its executives entered into a settlement agreement with the OSC Staff on January 27, 2009, which was approved by the OSC on February 5, 2009. Pursuant to the settlement, RIM must undergo an extensive review of its governance practices by an independent consultant; however, it was not subject to any monetary penalties. Rather, the extensive monetary penalties were

levied on RIM's executives and directors for a whopping total of \$77 million. Among other orders, James Balsillie and Mike Lazaridis, the co-CEOs, and Dennis Kavelman, the then CFO and now COO, were ordered to contribute \$38.3 million to RIM in respect of the outstanding benefit arising from the incorrectly priced stock options, along with contributing \$44.8 million (minus \$15 million already paid) to RIM to defray the investigation costs and the costs of remedying its compensation governance practices.<sup>2</sup>

The terms of the settlement are in line with the largest stock option backdating settlement to date in the U.S, taking into account the amount of the

## Executive Compensation: Hot Topics in the U.S.

By David G. Johnson

Executive compensation and governance have been increasingly under the spotlight of governments, the media, investors and other stakeholders internationally and, certainly, in the U.S. The level of scrutiny in the U.S. has heightened in recent years due to a variety of factors, such as: the perception of continuing pay increases, notwithstanding unsatisfactory performance; the perception of excessive pay trends based on ineffective governance processes; and, financial statement restatements after significant incentive payments based on incorrect statements. Most recently, the severe challenges in the financial services sector was thought by some to be fuelled, at least in part, by executive pay strategies that incited excessive risk taking. Then came "TARP" and the Stimulus bill that followed.

On February 17, 2009, the *American Recovery and Reinvestment Act of 2009* was signed into law. This new law included several significant restrictions on executive compensation for enterprises receiving assistance under the Troubled Asset Relief Program (TARP). The new rules affecting TARP participants include numerous provisions addressing corporate governance, pay limitations, compensation claw-backs, severance prohibitions, risk assessments and others. It is believed by some that the U.S. Government's involvement in executive compensation in the context of TARP could well influence pay practices for companies outside the scope of TARP. How this all plays out remains to be seen, but the ongoing scrutiny of executive compensation and governance practices will likely remain significant for the foreseeable future. In fact, we are probably heading into pay revolution, rather than pay evolution.

Scrutiny aside, there are numerous pressing business issues in today's economic environment that are presenting chal-

lenges to some companies, such as:

- Underwater stock options
- Increased workload and responsibilities due to layoffs
- Elimination or reduction of employee benefits
- Retaining and motivating key talent during an economic downturn in the face of zero bonus payouts and other pay reductions
- Increased focus on compliance and risk management associated with compensation and benefit practices

These pressing business issues, among others, are adding to the urgency for companies to reassess pay strategies and structures in this highly unusual economic climate. While modifying compensation strategies is a strategic business matter, the considerations associated with program changes must also include an assessment of cost effectiveness, tax and financial efficiency, sensitivity to investor issues, proper alignment with corporate and individual performance and the effectiveness of program structures in foreign jurisdictions. In addition, businesses recognize the importance of maintaining competitive pay programs; yet, getting a handle on competitive pay practices is challenging in a climate where statistics and data are changing on a daily basis. Adding all this together, you have a balancing act more delicate than usual, to say the least.

While some companies are proceeding cautiously and perhaps taking somewhat of a wait-and-see approach on certain of these issues, others are taking significant action. It's difficult to forecast how the rest of 2009 will play out in the executive compensation arena but, suffice it to say, it will not be "business as usual".

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settlement and the impact on the financial restatements. The largest settlement in the U.S. to date involves the former CEO and Chairman of United Health Group Inc., William W. McGuire M.D. Pursuant to SEC allegations, from at least 1994 to 2005, McGuire M.D., retroactively fixed grant dates to those with historically low closing prices for the company's stock and the company did not record the compensation expense as required by accounting rules. The case settled for \$468 million and the company restated its financial statements for those years and disclosed material cumulative pre-tax errors in stock-based compensation accounting totalling US\$1.526 billion.<sup>3</sup>

### Pay-cut Club: Who's in, Who's out?

With the collapse of the financial services industry in developed countries around the world, excessive executive pay in the industry has been making global headlines. Recently, the banks' needs for government bailouts in France and the U.S. have come with conditions – restrictions on executive pay. France's top bankers waived their 2008 bonuses in exchange for government aid. In the U.S., the TARP guidelines include a \$500,000 annual deduction limit on executive pay for institutions seeking government aid, along with other restrictions.<sup>4</sup>

Canada's banks are not facing any similar government imposed caps on compensation. Nonetheless, it seems our bank leaders are cognisant that there may be less shareholder appetite for excessive pay in the current economic crisis. CEOs at Royal Bank of Canada, Canadian Imperial Bank of Commerce and Bank of Montreal voluntarily gave up a combined total of approximately \$15 million in compensation. The Toronto-Dominion Bank CEO voluntarily forfeited \$3 million of equity awards, which the bank will instead donate to charities chosen by the CEO. Unlike the other bank CEOs, the CEO of the Bank of Nova Scotia has kept the full compensation awarded. In addition, the CEO of National Bank of Canada will receive his full 2008 compensation, taking into consideration the bank's results were well above the

average of the other major Canadian banks.<sup>5</sup>

### Plunging Stocks & Rising Stock Ownership Guidelines

Over the past decade, many organizations introduced or increased stock ownership guidelines for directors. The ownership guidelines generally require directors to acquire within a limited period of time, and continue to own, a multiple of their annual retainer in company stocks. Often, the multiplier ranges from two to six times the director's annual retainer, but it may be much higher.

The rapid onset of the economic crisis and its drastic effect on financial markets may be putting increased pressure on directors seeking to meet and maintain their stock ownership requirements. As a result of these pressures, organizations should review their stock ownership guidelines and assess if any changes are required. Changes could include extending the period within which stock ownership guidelines must be met or fixing the timing for when stock is valued for the purposes of the ownership guidelines. For example, Canadian Imperial Bank of Commerce extended the period for meeting share ownership requirements if they fell offside due to the market. Bank of Montreal broadened the valuation date to include the year-end value or the acquisition cost of the stock.<sup>6</sup>

### Compensation Governance: Under Review

#### Proposed New Insider Reporting Requirements

On December 19, 2008, the Canadian Securities Administrators (CSA) published for a 90-day comment period ending on March 19, 2009, the proposed National Instrument 55-104 *Insider Reporting Requirements and Exemptions*, Companion Policy 55-104 CP *Insider Reporting Requirements and Exemptions* and related consequential amendments (collectively, the Proposed Insider Reporting Materials).<sup>7</sup> The Proposed Insider Reporting Materials will modernize and harmonize the main insider reporting requirements and exemptions for insiders of reporting

### New from the OSC: Executive Director Settlements

The Ontario Securities Commission (OSC) published new Guidelines for Executive Director's Settlements of enforcement matters, effective November 28, 2008.<sup>10</sup> Executive Director settlements are a means of resolving matters before formal proceedings are commenced under the *Securities Act*.<sup>11</sup> They enable OSC staff, with the consent of the Executive Director, to resolve enforcement matters by entering into a voluntary settlement agreement with the party involved. Once formal proceedings are commenced, settlements must be approved by a panel of Commissioners. The new guidelines provide general guidance on: (1) the nature of matters that may be resolved by an Executive Director's Settlement; and (2) the factors the Executive Director may consider in approving such a settlement.

issuers across Canada, except in Ontario. In Ontario, the main insider reporting requirements will remain in the *Securities Act*.<sup>8</sup> Consolidating the insider reporting requirements into a national instrument, from the existing statutes, rules and regulations across jurisdictions will simplify the reporting process for insiders and issuers and help promote timely and effective compliance. The Proposed Insider Reporting Materials will:

- Reduce the number of persons required to file insider reports
  - Accelerate the filing deadline for insiders from 10 calendar days to 5
  - Simplify the reporting requirements for security-based compensation arrangements
  - Permit issuers to file a grant report
  - Require disclosure in the information circular of any late filings by insiders
- The proposed changes would bring our insider reporting requirements more in-line with the U.S. In the U.S.,

the insider reporting requirements: (a) apply to a much narrower class of persons than our current requirements; (b) generally have filing deadlines of two-business days from the transaction; and (c) provide clear instructions for reporting different types of security-based arrangements, unlike our inconsistent treatment of phantom stock, share appreciation rights, restricted and deferred share units and other similar instruments. Having recently brought our executive compensation disclosure requirements more in-line with the U.S. with the introduction of our new disclosure rules, it follows that our insider reporting obligations in respect of that compensation would also be brought in-line.

### Proposed New Corporate Governance Disclosure

On December 19, 2008, the CSA published for a 120-day comment period ending on April 20, 2009, the proposed repeal and replacement of National Policy 58-201 *Corporate Governance Guidelines*, National Instrument 58-101 *Disclosure of Corporate Governance Practices* and National Instrument 52-110 *Audit Committees* and Companion Policy 52-110CP *Audit Committees* (collectively, the Proposed Governance Materials).<sup>9</sup> The Proposed Governance Materials were developed following the CSA's review of existing governance requirements to ensure they continue to be appropriate for issuers in the Canadian market. The Proposed Governance

Materials are intended to enhance the standard of governance and confidence in the Canadian capital markets. They are broader in scope and more principles-based than the existing governance requirements. They require more disclosure on the independence of the audit committee members and introduce three new subject matters, namely, the requirement for the board to:

- Establish a system to recognize and manage actual and potential conflicts of interest
- Establish a framework to recognize and manage risk
- Stay informed of shareholders' views through shareholder meetings and on-going dialogue

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The foregoing is provided for information purposes only and reflects the views only of the author. It does not constitute legal, tax, accounting, compensation consulting or other professional advice and cannot reasonably be relied upon as providing such professional advice.

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- <sup>1</sup> Financial Release "RIM Provides Status Update and Reports on Results of Internal Review of Stock Option Grants by Special Committee" (05 March 2007), online:[http://www.rim.com/investors/releases/2007/pr-05\\_03\\_2007-01.shtml](http://www.rim.com/investors/releases/2007/pr-05_03_2007-01.shtml) [RIM Status Update]; Nadine Côté, *Executive Compensation: A Director's Guide* (Toronto: CCH, 2006+) at 6-10.
- <sup>2</sup> RIM Status Update, *ibid.* Janet McFarland and Paul Waldie, with a report from Sinclair Steward, "RIM trips on offering options to employees; 'So did we do backdating? Yeah, we did backdating,' CEO of BlackBerry firm says" *The Globe and Mail* (6 March 2007) A1; Ontario Securities Commission Order (Sections 127 and 127.1) (27 January 2009).
- <sup>3</sup> SEC "Former UnitedHealth Group CEO/Chairman Settles Stock Options Backdating Case for \$468 Million - Settlement Is Largest to Date in an Options Backdating Case 2007-255 (6 December 2007) online: <http://www.sec.gov/news/press/2007/2007-255.htm>.
- <sup>4</sup> AP, "France's top bankers agree to forego bonuses" *The Globe and Mail* (21 January 2009) B10; Paris Bureau "BNP Paribas top executives to forego 2008 bonuses: report" *Market Watch* (18 January 2009) online: [http://www.marketwatch.com/news/story/bnp-paribas-top-executives-forego/story.aspx?guid=%7B247FE17D%2D244F%2D4B8E%2DA483%2DA3046B50DC12%7D&dist=msr\\_6](http://www.marketwatch.com/news/story/bnp-paribas-top-executives-forego/story.aspx?guid=%7B247FE17D%2D244F%2D4B8E%2DA483%2DA3046B50DC12%7D&dist=msr_6).
- <sup>5</sup> Sinclair Steward, "Bay Street's new calculus" *The Globe and Mail* (2 February 2009) B1; Bertrand Marotte, "National Bank CEO won't join pay-cut club" (4 February 2009) B9; Eoin Callan, "TD chief donating \$3m of his bonus to charity" *National Post* online: <http://www.nationalpost.com/related/topics/index.html?subject=TD+Bank+Financial+Group&type=Company>; The Toronto-Dominion Bank, "Management Proxy Circular" (02 April 2009).
- <sup>6</sup> Janet McFarland, "Falling stocks squeeze board ownership rules" *The Globe and Mail* (09 February 2009) B1 & B10; Spencer Stuart "Canadian Spencer Stuart Board Index: Board Trends and Practices of Leading Canadian Companies" (February 2009).
- <sup>7</sup> Notice and Request for Comment Proposed National Instrument 55-104 *Insider Reporting Requirements and Exemptions*, Companion Policy 55-104 CP *Insider Reporting Requirements and Exemptions* and related consequential amendments (2008) 31 O.S.C.B. 12117 [collectively, the Proposed Insider Reporting Materials].
- <sup>8</sup> *Securities Act*, R.S.O. 1990, c. S.5 as am. [*Securities Act*].
- <sup>9</sup> Request for Comment Proposed Repeal and Replacement of National Policy 58-201 *Corporate Governance Guidelines*, National Instrument 58-101 *Disclosure of Corporate Governance Practices* and National Instrument 52-110 *Audit Committees* and Companion Policy 52-110CP *Audit Committees* (2008) 31 O.S.C.B. 12158 [collectively, the Proposed Governance Materials].
- <sup>10</sup> Ontario Securities Commission – Guidelines for the Approval by the Executive Director of Settlements of Enforcement Matters (2008) 31 O.S.C.B. 11407.
- <sup>11</sup> *Securities Act*, supra note 8.

A comprehensive review of executive compensation is available in the regularly updated loose-leaf book published by Thomson Reuters Canada Ltd., titled "*Executive Compensation: A Director's Guide*" by Nadine Côté.