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2023: Time to revisit your equity plan design and disclosure

JANUARY 11, 2023 10 MIN READ

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This year, new Canadian non-GAAP disclosure rules and TSX Venture Exchange (TSX-V) listing requirements have had an impact on Canadian issuers, especially those listed on the TSX-V. U.S. rulemaking over the course of the last 12 months is expected to result in material changes to design and disclosure of executive compensation arrangements for Canadian issuers listed on U.S. stock exchanges in 2023 and beyond. These new U.S. rules may eventually influence Canadian rules or practice in the future.

Executive compensation disclosure

Changes to disclosure of specified financial measures

As we wrote in our Capital Markets article, this year saw National Instrument 52-112 – Non-GAAP and Other Financial Measures Disclosure (NI 52-112) begin to affect executive compensation disclosure. Executive compensation disclosure rules still require that when an issuer discloses performance goals or similar conditions that are non-GAAP financial measures, the issuer must explain how the issuer calculated those performance goals or similar conditions from its financial statements. However, although NI 52-112 generally does not apply to executive compensation disclosures, the instrument now imposes additional requirements with respect to non-GAAP financial measures and new requirements when disclosing total of segments measures and certain capital management measures in executive compensation disclosure.

In particular, issuers must ensure each non-GAAP financial measure is identified as a non-GAAP financial measure. In addition, issuers must provide a quantitative reconciliation in the permitted format of each non-GAAP financial measure to its most directly comparable financial measure disclosed in the issuer's primary financial statements (GAAP measure). Issuers must also disclose each total of segments measure and each capital management measure that is not disclosed as a ratio, fraction, percentage or similar representation to its most directly comparable financial measure.

Issuers considering whether to adjust a financial measure for compensation purposes must bear in mind they will need to identify the financial measure as being non-GAAP and provide a quantitative reconciliation to the nearest GAAP measure.

New U.S. pay for performance disclosure requirements

Long-delayed U.S. rules mandating pay for performance disclosure were issued in final form. These rules will apply to proxy statements covering fiscal years ending on or after December 16, 2022. Canadian issuers that are required to provide executive compensation disclosure in

accordance with U.S. rules, or that choose to follow U.S. rules in satisfaction of Canadian executive compensation disclosure requirements, will need to comply with new requirements.

As further detailed in our Osler Update, the new rules will require disclosure of compensation "actually paid" to the CEO and average compensation "actually paid" to all the other named executive officers over a period of five years, in comparison to certain measures of performance, including the total shareholder return of the issuer and of its peer group. Narrative disclosure of the comparison between the financial measures and the compensation actually paid will also be required. The amount of compensation "actually paid" will be the executive's total compensation from the Summary Compensation Table, adjusted for items such as the actuarial value of pension benefits, the vesting date value of equity awards that have vested and the year-end fair value of unvested equity awards.

Only Canadian issuers that provide executive compensation disclosure in accordance with the rules of the U.S. Securities and Exchange Commission (SEC) are required to comply with these new rules. However, larger Canadian issuers that currently provide a voluntary five-year lookback table for CEO compensation paid may wish to consider whether to modify their approach to take these changes into account.

Executive compensation design

TSX Venture issuers must adopt new equity compensation plans

On November 24, 2021, changes to the TSX-V's policies regarding securities-based compensation became effective, requiring issuers listed on the TSX-V to revise their equity compensation plans. The changes to TSX-V Policy 4.4 were substantial. The policy now explicitly contemplates different types of awards, such as restricted and performance share units, deferred share units and stock appreciation rights, in addition to stock options. Previously the policy only addressed incentive stock options. Due to the nature of the changes to Policy 4.4, it may be easier in some cases for an issuer to adopt a new plan that complies with the new TSX-V rules rather than amend an existing plan.

New information return and designating share-settled restricted share units and performance share units as non-qualified securities

Under the Canadian *Income Tax Act*, when an employee exercises an employee stock option and acquires shares, the employee realizes a taxable employment benefit. The benefit is equal to the excess of the value of the shares at the time of acquisition over the exercise price paid for the shares. If the exercise price of the option is fixed at an amount that is not less than the fair market value of the share at the time the option was granted, and as long as certain other conditions are met, the employee may be entitled to claim a deduction equal to one-half of the taxable benefit. It is this deduction that allows stock option benefits to be taxed at effectively the same tax rate applicable to capital gains.

As a result of the enactment of Bill C-30, the federal budget implementation bill, the availability of the deduction is now subject to a $200,000 annual vesting limit for certain stock options granted on or after July 1, 2021. In cases where the new rules apply, the employer may also choose to designate, at the time of the grant, the underlying securities as "non-qualified securities." Such a designation disqualifies the employee from claiming the deduction with respect to the non-qualified securities.

Employers are required to notify the employee and the CRA if the underlying security is designated as a non-qualified security. The notice to the employee must be made in writing within 30 days after the date on which the stock option was granted, though a specific form of notice to the employee has not been prescribed. The notice to the CRA must be made by filing an information return using the Schedule 59 prescribed form on or before the grantor's filing due date for the taxation year in which the stock option was granted.

During the CRA Roundtable at the 2022 International Fiscal Conference, the CRA stated that the Department of Finance is considering how to deal with a potential issue in the drafting of the rules relating to the $200,000 annual vesting limit. The rules as currently drafted are overbroad. They appear to capture restricted share units (RSUs), performance share units (PSUs) and other rights to securities that are subject to section 7 of the Tax Act because they must be settled in newly-issued shares. However, such rights would never entitle the employee to the deduction under paragraph 110(1)(d) of the *Income Tax Act*.

According to the CRA, the Department of Finance is contemplating potential remedial measures and will address the question of whether such securities should count towards the $200,000 annual vesting limit at a later date. In the interim, the CRA advises employers to avoid this problem by designating the securities underlying such awards as non-qualified securities. Therefore, for the time being, companies that grant RSUs and/or PSUs that must be settled in newly-issued shares should formally designate such awards as non-qualified securities. Failing to do so could reduce availability under the $200,000 annual vesting limit even though such awards are not eligible for treatment under paragraph 110(1)(d) of the *Income Tax Act*.

New clawback rules will apply to all U.S.-listed issuers

Other new SEC rules, also released in final form after considerable delay, will require U.S. stock exchanges to issue new requirements for listed issuers, including Canadian listed issuers, to adopt, disclose and enforce new policies for the clawback of incentive compensation from executive officers. Additional detail is included in our blog post.

With limited exception, clawbacks under the policy will be triggered by the restatement of financial results previously reported by the issuer. If a covered restatement occurs, then, regardless of fault, the pre-tax, excess incentive compensation received by executive officers as a result of measures based on the restated financial results must be clawed back. There is a three year look back period for determining if the clawback applies, which is the three fiscal years prior to the date the issuer became required to issue the restatement. The issuer will also be required to file a copy of its clawback policy with the SEC as an exhibit to its annual report.

If the clawback policy is triggered, the issuer will be required to publicly disclose status reports regarding its recovery efforts. Reports must include the amounts owing from each current or former named executive officer from whom recovery is not being pursued, and from whom unrecovered amounts have been outstanding for more than six months. The same information will be required to be reported for all other executive officers as a group. Stock exchange rules will prohibit the issuer from indemnifying executive officers against any recovery under the clawback policy.

The SEC chose not to make changes, despite receiving comments highlighting the challenges the new listing requirements will create for Canadian and other foreign private issuers. For example, incentive compensation awarded pursuant to plans or arrangements in place prior to the date the stock exchange listing rules become effective will still be subject to the clawback policy. Further, an issuer cannot forgo collection of amounts under the clawback policy unless it can deliver a legal opinion to the exchange stating that recovery is illegal

under the laws of its jurisdiction of incorporation. Those laws may not be the same as the laws that govern the issuer's relationship with an executive officer. Finally, an issuer will be required to disclose how amounts to be recovered were calculated.

The SEC's final rule was published in the Federal Register on November 28, 2022. New stock exchange listing standards implementing the final rule must be issued by February 26, 2023, and take effect no later than November 28, 2023. Issuers will have 60 days from the effective date of the new listing standards to adopt a compliant clawback policy. Accordingly, Canadian issuers listed on U.S. stock exchanges should adopt or revise clawback policies over the next several months as they will be required to have such a policy in place no later than January 27, 2024 or potentially much sooner, depending on which U.S. stock exchange they are listed on.

U.S. revisiting rules on automatic securities disposition (10b5-1) plans

On December 15, 2021 and January 13, 2022 [PDF], the SEC issued for comment proposed amendments to Rule 10b5-1. This rule permits the automatic disposition of shares pursuant to a plan by persons who may have access to material non-public information. Among other things, the proposals would require a cooling off period before trading could commence under a new or modified plan. Only one automatic trading plan would be permitted to operate at a time in respect of a class of securities. Officers and directors would be required to certify they do not possess any material non-public information when they adopt the plan.

Issuers, including foreign private issuers filing on Form 20-F, would be required to provide disclosure about their policies and procedures related to insider trading, as well as their practices around the timing of options grants and the release of material non-public information. The proposals further contemplate periodic disclosure with respect to any options granted within 14 days of the release of a periodic report, a report containing material non-public information or an issuer share repurchase.

Finally, the proposals would also require disclosure of the market price of the underlying securities the trading day before and the trading day after the disclosure of the material non-public information. However, this requirement would not apply to foreign private issuers filing on Form 20-F or Canadian multijurisdictional disclosure system issuers filing on Form 40-F.

Although the comment period for the proposed rule expired on April 1, 2022, a final rule has not yet been issued.

Revisiting equity compensation repricing

Increasing interest rates and the possibility of a recession may affect the financial performance and share trading price of many issuers. For example, issuers that made sizable option grants to address retention concerns or as a result of going public over the last few years may find that many such grants are underwater or out-of-the-money, where the share value is less than the exercise price of the option. In that case, the options would no longer provide a meaningful incentive to the management team.

As we have previously noted, repricing of stock options is challenging. There are many factors to consider when contemplating changes to stock option programs to address underwater stock options.

Conclusion

During the coming year, many issuers, especially interlisted issuers and TSX-V issuers, will need to consider potential changes to the design of their compensation arrangements. At the same time, the risk of a potential economic downturn will create new challenges. Issuers will have to balance the need for flexibility to address the impacts of economic challenges, with increased requirements for transparency.