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The New Executive Compensation Disclosure Rules

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Christina Medland and Cornell Wright discuss Canada's new rules for executive compensation disclosure.

Edited transcript

Why were the new executive compensation rules introduced?

There was a broad consensus that the current rules, which were introduced in 1994, had failed to keep pace with changing and increasingly complex executive compensation practices. The new rules follow — I guess, respond to — demands from investors for more and better information about compensation practices and also replicate in many ways the quite stringent rules that were introduced to the U.S. by the SEC. The new rules will represent a quantum leap forward even for those companies that have in the past done an admirable job of disclosure. They will require companies to report all compensation — emphasizing substance over form. They really put a premium on companies explaining the rationale for specific compensation decisions and they will emphasize the need to demonstrate the link between pay and performance.

What lessons can Canadian companies take from the U.S. experience?

The Canadian rules are similar — although not identical — to the overhauled rules that the SEC introduced a couple of years ago. [Firstly,] Canadian companies can benefit hugely, as we have, from going through a sampling of U.S. companies' disclosures and understanding the significant thinking that U.S. companies have done on some of the critical issues that will also confront companies here under our new rules. And secondly, the SEC has published quite significant guidance on how to interpret its new rules. Two themes have emerged from the reviews that the SEC has done of U.S. companies' disclosure. Firstly, that the CD&A (compensation discussion and analysis) really needs to focus on analyzing how and why compensation decisions were made – less emphasis on taking readers through the mechanics of compensation process and procedures and more focus on analysis, similar to the kind of analysis that a company does in its MD&A (management's discussion and analysis). Secondly, the SEC indicated that the manner of presentation matters. We should go back to good disclosure principles: plain English, emphasizing material information, de-emphasizing less material information, and using charts and tables to help readers understand the key points that are made.

What are some of the significant changes to executive compensation disclosure under the new rules?

There are really three significant changes in the new rules. The first is the introduction of the CD&A, the Compensation Discussion and Analysis. This is like the MD&A but without the certification process. The second is that determining who your named executive officers are will now be determined on the basis of total compensation, not just on the basis of bonus and base salary; so that includes the value of equity

awards. The third, and quite significantly, is that termination compensation now needs to be disclosed on a financial basis. So you look at what you would have had to pay your executive if there had been a change of control or some cessation of employment, as at the end of the last fiscal year.

How will the new CD&A rules affect companies' compensation decisions?

The new rules in the CD&A require quite detailed discussion of a number of aspects of compensation. Companies are required to disclose the objectives of their compensation program, what elements are in that compensation program, how the elements interrelate and how the total compensation philosophy relates to each of those elements.

The things that are now required to be specifically dealt with in the CD&A are going to enforce better discipline on companies. They are going to have to look more carefully at their compensation decision making. That's going to lead to better processes and, in turn, to better decision making. Good companies are already doing this, but for small to middle-size companies, this is going to be a quite significant change in their practice.

What are companies most concerned about under the new rules?

The question that we've been getting most commonly from our clients relates to the disclosure of performance targets. Companies seem to be concerned about this for two primary reasons. The first is that they are concerned that the disclosure of their compensation targets is going to lead to the disclosure of competitively sensitive information. The second is that they are concerned that the disclosure of this information is actually the provision of forward-looking information, without the usual safeguards that companies provide when they're giving that kind of information.

We expect that in the first year, companies are going to be cautious in how they disclose this information. And in fact that's what happened with U.S. companies under the new U.S. rules.

What steps do your recommend that companies take to prepare for the new disclosure regime?

Companies should leave themselves lots of time to prepare their compensation disclosure for 2008: there are a lot of people — a lot more people — who will need to be involved; the compensation committee will be more engaged; and there's a lot more information that'll need to be gathered, analyzed and diligenced.

Producing a good CD&A requires companies to think hard about what their key compensation messages are. In addition, companies should make sure that those messages are consistent with the messages that they're giving the world about their business performance and prospects in their MD&A and other investor communications. Finally, in our experience, it's invariably the case that all the work that goes into producing good compensation disclosure leads companies to re-think their compensation policies, programs and decisions; and companies need to leave time for that thinking as well. T