University of Miami Inter-American Law Review

10-1-2007

Executive Fraud and Canada's Regulation of Executive Compensation

Bo James Howell

Recommended Citation
Bo James Howell, *Executive Fraud and Canada's Regulation of Executive Compensation*, 39 U. Miami Inter-Am. L. Rev. 111 (2007)
Available at: http://repository.law.miami.edu/umialr/vol39/iss1/4

NOTES

Executive Fraud and Canada's Regulation of Executive Compensation

Bo James Howell*

I. INTRODUCTION 111
II. EXECUTIVE COMPENSATION AND CORPORATE SCANDAL 113
   A. *Current Compensation Levels in Canada* 116
III. THE CANADIAN REGULATORY STRUCTURE 117
IV. CANADIAN REGULATION OF EXECUTIVE COMPENSATION 119
V. OVERHAULING THE RULES OF EXECUTIVE COMPENSATION IN CANADA 120
VI. ONE SIZE DOESN'T FIT ALL 122
   A. *European Union* 122
   B. *France* 126
   C. *Germany* 129
   D. *Luxembourg* 131
   E. *United Kingdom* 133
   F. *United States* 135
VII. CANADIAN RULES FOR A CANADIAN SYSTEM 140

I. INTRODUCTION

Across boardrooms, academia, governments and the media, executive compensation is being discussed with increased regularity. Today, executive compensation is regarded as a "hot topic" in both the legal and business communities. For the most part, the issue of corporate governance has only recently focused on executive compensation.[1] In addition, the recent focus of executive compensation has primarily "been on the total dollar value of

---

* J.D. Candidate 2008, Gonzaga University; B.A. 2005, Washington State University. 2007 SEC Summer Honors Legal Program – Division of Corporate Finance, *Office of International Corporate Finance*.

1. INST. OF CORPORATE DIRECTORS., ICD BLUE RIBBON COMMISSION ON THE GOVERNANCE OF EXECUTIVE COMPENSATION IN CANADA, at iii (Jun. 2007) [hereinafter ICD REPORT] *available at* http://www.icd.ca/scriptcontent/blueRibbonDownload.cfm?section=News (free registration required).

executive compensation packages as opposed to the crucial governance-related function that compensation plays within an organization."[2] When compared to the U.S., however, the executive compensation levels in Canada are significantly less.[3] During the early 1990s compensation for most of Canada's top executives was about 50% of the American average.[4] As a result, "[c]ompensation levels in Canada have not generated the same amount of attention as they have in the United States."[5]

Despite the difference in compensation levels, Canada is actively scrutinizing its current executive compensation laws. Following corporate scandals in both Canada and the U.S., many people are calling for an overhaul of Canada's regulatory scheme, especially in the area of executive compensation. While total compensation remains the primary focus, many actors are concerned about "the role of executive compensation as a governance mechanism . . . ."[6]

Executive compensation packages are supposed to align the corporate officer's interest with the interest of the company and its shareholders.[7] If utilized correctly, compensation packages can be an effective tool for regulating corporate governance. Any regulation of corporate governance, however, must be well-informed and clearly structured. When the U.S. overhauled its regulation of executive compensation in the early 1990s companies simply adapted their packages to include more incentive-based compensation, which allowed them to avoid the intended purpose of the new regulations.[8] The end result is the current proliferation of options backdating scandals.

This article comments on Canada's current discussion of executive compensation laws and regulations. Part II provides a general discussion of the relationship between executive

---

2. *Id.*

3. Benjamin Alarie, *Executive Compensations and Tax Policy: Lessons for Canada from the Experience of the United States in the 1990s,* 61 U. TORONTO FAC. L REV. 39, 44 (2003).

4. Xianming Zhou, *Executive Compensation and Managerial Incentives: A Comparison Between Canada and the United States,* 5 J. OF CORP. FIN. 277, 300 (1999) *cited in* Alarie, *supra* note 3, at 44.

5. ICD REPORT, *supra* note 1, at 8. Canadian compensation packages are smaller for a number of reasons, including a smaller average firm size, emphasis on salary, cultural influences, and competitiveness of markets.

6. *Id.* at 7.

7. *Id.*

8. *Id.* at 8-9. The new regulations were supposed to make it more difficult for large companies to pay executives enormous salaries.

compensation and corporate scandal. With the background set, Part III presents the current executive compensation laws and regulations in Canada. Part IV looks at Canada's current plans to overhaul its executive compensation. In Part V, I introduce the current U.S. and European approaches to executive compensation regulation. Finally, Part VI discusses the direction that Canada should proceed in light of the various approaches.

II. EXECUTIVE COMPENSATION AND CORPORATE SCANDAL

Corporate fraud can be viewed from an economic perspective, where the costs of the fraud (i.e. the severity of the punishment, both criminal and civil, and the likelihood of being caught) are balanced against the benefits (i.e. the potential financial pay-off).[9] While the cost-benefit analysis cannot be applied across the board and its application depends on the ethical foundation of each individual executive, it can be used in a broad regulatory sense.[10] Not surprisingly, recent studies have found that corporate executives who commit fraud have "financial incentives that are 69% greater than" the average compensation package.[11] Most of these incentives constitute large, unrestricted stock and option holdings, which "are 115% larger than comparable incentives for the median control executive."[12]

Incentives or pay-outs are not the only benefits that may compel an executive to commit corporate fraud. Quantity of opportunity may supersede the quality of the incentive.[13] While security regulators can reduce the incentive by increasing the penalties, reducing the opportunities may be a more effective means of preventing corporate fraud. Reducing corporate fraud through increased disclosure and transparency of executive compensation

9. *See* Shane A. Johnson, Harley E. Ryan, Jr, & Yisong S. Tian, Executive Compensation and Corporate Fraud 1 (July 23, 2003) (unpublished draft, *available at* http://www.wlu.ca/documents/10886/tian.pdf) (referring to "Becker's (1968) economic theory of crime framework. . ."). A similar paper by the same authors has since been published under a different title, as Shane A. Johnson, Harley E. Ryan and Yisong S. Tian *Managerial Incentives and Corporate Fraud: the Sources of Incentives Matter* (EFA 2006 Zurich Meetings) *available at* SSRN: http://ssrn.com/abstract=395960.

10. *See* Johnson et al., *supra* note 9, at 1 n.1 (stating that increased incentives may entice more executives to corporate fraud).

11. *Id.* at 2 (the study used "firms that are the subjects of the Securities and Exchange Commission's (SEC) Accounting and Auditing Enforcement Releases (AAERs) . . . ." While the numbers do not reflect data from Canadian firms, I assume that the similarity and closeness of the two markets produce similar data).

12. *Id.*

13. *See id.* (noting that executives may commit greater fraud simply because there is greater opportunity).

is more effective for a number of reasons. First, heightened disclosure requirements allow stockholders to perform the role of overseer. Second, covering up frauds will be much more difficult, i.e., with more transparency a potential fraud will be increasingly difficult to hide. Finally, many civil penalties that arise out of executive fraud are paid for by the corporation and therefore, the shareholders. Efficient regulation should target the individuals responsible for the fraud and use an effective balance of individualized civil and criminal penalties.

Ultimately, the more difficult it is for shareholders and boards of directors to monitor corporate executives, the more they must align the executive's interest with their own.[14] This in turn creates greater incentives for would-be defrauders,[15] but if these incentives are disclosed – along with other areas of corporate governance – the fraud will be more difficult to cover-up. The end result is that shareholders and boards of directors can provide executives with large incentives, while reducing the opportunity to commit fraud.

There are two primary approaches to controlling corporate fraud through executive compensation: "the optimal contracting approach and the managerial power approach."[16] The two approaches can be summarized as follows. First, "the optimal contracting approach . . . assumes that it is possible to design a compensation scheme that provides managers with incentives to maximize shareholder value."[17] Essentially, the compensation package is meant to align the interests of the executive with those of the shareholders so that the benefit of one is the benefit of the other. The theory is based on economics and suggests that an optimal package can be achieved through negotiation and market forces.[18]

The competing theory, "the managerial power approach, recognizes that compensation packages are designed through the input of many individuals with different incentives."[19] One unique aspect of this theory is the process of rent-seeking.[20] Rent-seeking

14. *Id.* at 4.
15. *Id.*
16. ICD Report, *supra* note 1, at 9.
17. *Id.*
18. *See id.* at 10 (stating that the reaction of market forces to optimal contracting arrangements creates an efficient alignment of shareholder and executive interests).
19. *Id.*
20. *See id.* (stating that contracts may reflect rent-seeking as opposed to incentive alignment).

is "[t]he process by which an [executive] seeks to gain through manipulation of the economic environment rather than through trade and the production of added wealth. Rent seeking generally implies the extraction of uncompensated value from another without taking action which improve productivity."[21] Essentially, the managerial approach includes optimal contracting and management manipulation.[22] The managerial theory is present whenever corporate executives directly influence the creation of compensation packages.[23]

Ultimately, the use of negotiated contracts is present under both theories. The use of compensation contracts to align executives with shareholder interests, however, is a double-edged sword. Past publications have noted that "compensation contracts provide incentives for executives to take shareholder-wealth-increasing actions, [but] they also create incentives to misrepresent the performance measures underlying the contracts by producing fraudulent financial statement[s] or other information."[24] In order to mitigate the dangers of increased incentives in a compensation contract, strong corporate governance mechanisms should be established through applicable regulatory agencies.[25]

Consequently, the greater the incentives, the stronger corporate governance should be regulated.[26] Adopting a flexible approach that considers factors which could increase the incentives of fraud will allow corporate entities to reach the optimal level of corporate governance. A corporate governance scheme should consider (1) the growth opportunities of the corporation; (2) the amount of unrestricted equity-based compensation; (3) whether the industry has a history of corporate fraud; (4) the limitations on options and ability of corporate executives to sell stock over the short term.[27] Security regulators, both self-regulating organizations and government agencies, should be cognizant of the various factors that will affect the quantity and quality of corporate frauds. This awareness will allow such regulators to impose the optimal level of disclosure and transparency across the various industries and markets.

---

21. *Id.* at n.35.
22. *Id.* at 10.
23. *Id.*
24. See Johnson et al., *supra* note 9, at 6 (stating that "strong governance mechanisms could reduce the opportunity to commit fraud").
25. *Id.* at 27.
26. *Id.* at 32.
27. *See id.* (discussing the various factors impacting anti-fraud measures).

The reason that government regulators need to regulate corporate governance, albeit from a flexible business perspective, is that market forces "are not sufficiently strong and fine-tuned to assure optimal contracting outcomes."[28] The lack of executive talent and presence of frequent manipulation prevents the market from operating at an efficient level.[29] As a result, high-quality corporate executives have tremendous influence on their compensation and they know it.[30] In addition, markets are frequent victims of manipulation by corporate insiders. Outside the market, directors are not always informed, strong or interested enough to curb fraudulent or excessive executive compensation.[31] As a result, many compensation negotiations are ineffective at establishing a solid regulatory framework.

Increased disclosure and transparency will bolster the shareholder-regulatory impact of the "outrage effect." The outrage effect refers to the reaction by non-executive to excessive or fraudulent executive compensation.[32] "The more outrage a compensation arrangement is expected to generate, the more reluctant directors will be to approve the arrangement and the more hesitant managers will be to propose it in the first instance."[33] Ultimately, an effective regulatory scheme will punish the directors and not the shareholders. Further, an effective scheme will utilize shareholders to keep corporate executives honest.

A. *Current Compensation Levels in Canada*

In 2005, compensation for Canadian Chief Executive Officers (CEOs) surpassed the 2000 levels.[34] In 2000 the average compensation package equaled $2.2 million, while the 2005 average totaled $2.3 million.[35] From 2001 to 2003 compensation levels dropped, primarily because the amount of options granted decreased.[36]

Executive compensation for non-CEOs, however, is a com-

28. ICD REPORT, *supra* note 1, at 10; Lucian Arye Bebchuck & Jesse M. Fried, *Executive Compensation as an Agency Problem*, 17 J. Econ. Perspectives 3, 74 (2003).
29. ICD REPORT, *supra* note 1, at 10.
30. Bebchuck & Fried, *supra* note 28, at 74.
31. *See id.* (noting that "[t]hus, even a director who did not place much value on a board seat would still have little personal motivation to fight the CEO and her friends on the board on compensation matters").
32. *Id.* at 75.
33. *Id.*
34. ICD REPORT, *supra* note 1, at 11.
35. *Id.* at 12.
36. *Id.* at 11.

pletely different story. Between 2000 and 2002 compensation levels remained relatively stable.[37] Although 2003 and 2004 revealed decreases in compensation, the 2005 levels are similar to the 2000-2003 amounts.[38] Interestingly, "the difference between the compensation of the CEO and other named executives has increased during the past five years."[39] As the level of compensation for CEOs increases, so to does the level for non-CEOs, albeit at a slower rate.[40] Once again, the primary contributor to the increasing gap is the increased use of options for CEOs,[41] which may suggest a U.S. influence on executive compensation.

In general, the Canadian business culture has "a relatively low level of pay for performance sensitivity" when compared with the United States.[42] As a result, the percentage of executive compensation in the form of stock options is lower than the United States.[43] Despite the resistance to pay for performance compensation, studies have shown that companies "having more independent directors leads to higher compensation levels."[44] In addition, Canadian cross-listed "companies have compensation levels that are similar to their American counterparts versus non-cross-listed companies."[45] All of this data suggests that as more and more Canadian companies compete against U.S. companies, the compensation levels between to two camps begin to converge.[46] In addition, it is likely that Canadian and U.S. companies compete in the same corporate executive pool, which causes the two markets to converge even more.

III. THE CANADIAN REGULATORY STRUCTURE

Unlike the United States and some European Countries, the Canadian regulatory structure is comprised of several provincial

37. *Id.* at n.1.
38. *Id.*
39. *Id.* at 12.
40. *Id.*
41. *Id.* at 13.
42. *Id.* at 12.
43. *Id.*
44. *Id.* at 12-13.
45. *Id.* at 13.
46. In regards to Canadian-U.S. competition, it should be noted that over one-third of all foreign companies listed on U.S. stock exchanges are Canadian. In fact, at the end of 2006 Canadian companies equaled 491 of the 1,145 foreign companies listed on U.S. stock exchanges. Israel and the United Kingdom, who make up the second and third respectively, had a combined total of 145 listed companies.

or regional regulators.[47] "The majority of provinces have a two tiered structure, consisting of an upper appointed commission, and a lower level director and supporting staff."[48] Each regulator enacts its own laws and rules,[49] but their authority is limited to their geographical boundaries.[50] Ontario is the most influential Canadian regulator and its legislation has served as a model for other regulators.[51] In fact, Alberta, British Columbia, Manitoba, and Saskatchewan have all modeled their legislation after Ontario's laws.[52] Newfoundland and Nova Scotia have also followed Ontario, but to a lesser extent.[53]

The various provincial regulators have formed the Canadian Securities Administrators (CSA), which "implement[s] policy statements, and in most Canadian jurisdictions national instruments to harmonize the filing and approval requirements with regard to each of the separate jurisdictions . . . ."[54] In fact, there are four primary objectives shared between the various regulators:

> (1) the registration of persons and institutions trading in securities, and maintenance of the minimum standards necessary to retain registration; (2) the registration of securities distributed to the public by issuers; (3) the continuous and timely disclosure of relevant information to the investing public; and (4) the provision of the necessary investigative, preventative, and punitive mechanisms for the proper enforcement of the legislation.[55]

---

47. 10B INTERNATIONAL CAPITAL MARKETS AND SECURITIES REGULATION § 32:1 (Harold S. Bloomenthal & Samuel Wolf eds., 2007).

48. *Id.* (unlike the U.S. structure, the regional securities authority carries out the same duties as "both the SEC and the blue sky state authorities").

49. The various securities legislation include: (1) Securities Act, (Northwest Territories), (1988) (R.S.N.W.T.)(as amended); (2) Securities Act (Yukon Territories), (2002) (R.S.Y.); (3) Securities Act, (Alberta), (2000) (R.S.A.) (as amended); (4) Securities Act (British Columbia), (1996) (R.S.B.C.); (5) Securities Act, c. S50 (Manitoba), (C.C.S.M.); (6) Security Frauds Prevention Act, (New Brunswick), (1973) (R.S.N.B.) (as amended); (7) Securities Act, 1990 (Newfoundland), (1990) (R.S.N.L.) (as amended); (8) Securities Act, (Nova Scotia), (1989) (R.S.N.S.) (as amended); (9) Securities Act, (Ontario), (1990) (R.S.O) (as amended); (10) Securities Act, (Quebec), (R.S.Q.) (as amended); (11) Securities Act, 1988 (Saskatchewan), (1988) (S.S.) (as amended); (12) Securities Act (Prince Edward Island), (1988) (R.S.P.E.I.); and (13) Consolidation of Securities Act (Nunavut), (1988) (R.S.N.W.T.). *See id.* at 32:2 nn. 2-5.

50. *Id.* at § 32:2.

51. *Id.*

52. *Id.* (stating "[t]ogether the five provinces are known as the Uniform Act Provinces").

53. *Id.*

54. *Id.* at § 32:1.

55. *Id.*

In addition, the various regulators require four types of disclosure: financial, timely, insider reporting, and proxy solicitation and information circular requirements.[56] Generally, publicly available audited financial statements must be filed within 140 days of the financial year.[57]

IV. CANADIAN REGULATION OF EXECUTIVE COMPENSATION

Following the SEC's lead, Canadian regulators made "their first changes to executive compensation guidelines" in 1993.[58] These guidelines, which continue to be Canada's current requirements for executive disclosure, were implemented in 1994. Although Ontario's disclosure requirements were meant to mirror the SEC requirements when they were promulgated in 1993, the standards have since "evolved independently."[59] Both the U.S. and Canada use mandatory disclosure as a means of discovering abuses by corporate executives.[60]

Ideally, the transparency created by mandatory disclosure should notify shareholders of improper behavior by corporate executives.[61] However, the increased complexity of executive compensation packages results in today's investors receiving only portions of an executive compensation package.[62] Following the lead of the SEC, on March 29, 2007 the Canadian Securities Administrators (CSA) proposed amendments to the form and instruments of executive compensation requirements.[63]

Like the United States, Canada uses tables to track the composition of executive pay.[64] The tables are combined with "charts comparing the financial performance of the firm with similarly situated firms, and a textual explanation of the firm's compensation

56. *Id.* at § 32:22.

57. *Id.* at § 32:40.

58. ICD REPORT, *supra* note 1, at 1.

59. Alarie, *supra* note 3, at 60 n.66.

60. *Id.* at 60. (stating that today "companies listed on the TSX [Toronto Securities Exchange] are now subject to approximately the same level of mandatory disclosure as are American public corporations").

61. *Id.*

62. Introduction, Proposed Repeal and Substitution of Executive Compensation and Proposed Amendments to Continuous Disclosure Obligations, (Ont. Sec. Comm'n, proposed Mar. 29, 2007), *http://www.osc.gov.on.ca/Regulation/Rulemaking/Current/Part5/rule_20070329_51-102_rfc-pro-repeal-f6.pdf* [hereinafter Amendment 6.2.1].

63. *Id.*

64. Edward M. Iacobucci, *The Effects of Disclosure on Executive Compensation*, 48 U. TORONTO L.J. 489, 497 (1998).

policy."[65] While mandatory disclosure promotes transparency, it may also increase executive compensation because industry competitors will have an available benchmark to apply to their corporate executives.[66] Like many aspects in a market economy, companies will compete with each other for high-quality executives. The result will be expanding compensation packages as corporations attempt to lure highly-qualified individuals.

The push for regulatory reform is related to the U.S. Enron and options backdating scandals.[67] The use of options backdating based on non-public information violates both U.S. and Canadian securities laws.[68] As a result of the U.S. scandal, it was expected that Canadian regulators would follow the lead of the SEC to end illegal options backdating.[69] After the proposed amendments were published, it was clear that Canada is determined to prevent a similar scandal from breaking out in their respective markets.

V. Overhauling the Rules of Executive Compensation in Canada

Following the Enron scandal in the United States both the U.S. and Canada began to scrutinize their corporate governance laws.[70] Given the strong economic ties between the U.S. and Canada, such as the Multi-jurisdiction Disclosure System (MJDS), it is no surprise that a major scandal in the U.S. would cause Canada to overhaul its corporate governance laws.[71] Corporate scandal in the U.S., however, is not the sole reason for Canada's recent overhaul.[72] "Regulators in Canada want to protect investors and rebuild domestic and international confidence in Canada's capital markets in light of Canada's own corporate scandals . . . ."[73] Canada started its overhaul by creating laws similar to measures in the U.S. Sarbanes-Oxley Act (SOX).[74] Some of the primary measures include "certifications of annual and quarterly

65. *Id.*
66. Alarie, *supra* note 3, at 60.
67. Andrew J. Beck, Under Scrutiny: Governance in Canada, (2004), *available at* http://www.torys.com/publications/pdf/AR2004-8N.pdf; Torys, *The U.S. Backdating Scandal: What It Means for Canadian Issuers and Their Executives*, http://www.torys.com/publications/pdf/CM06-16T.pdf (Jul. 10, 2006).
68. Torys, *supra* note 67.
69. *Id.*
70. Beck, *supra* note 67, at 59.
71. *Id.*
72. *Id.*
73. *Id.*
74. *Id.* at 60.

reports [similar to] SOX Section 302" and independent and qualified auditing committees.[75]

The amendments are a reaction to a system which some regulators claim is outdated and ineffective.[76] The CSA believes that the proposed rules will "improve the quality and transparency of executive compensation disclosure."[77] The goal of the rules is to require companies to disclose all compensation awarded to corporate executives in a new, clear and informative format.[78] The CSA anticipates that the new rules' disclosure requirements will allow investors to make better assessments of a company and its performance.[79]

The proposals reflect the SEC's recent executive compensation rules.[80] The amendments target five key areas: (1) The summary compensation tables will require a total compensation column for every named executive officer (NEO); (2) a new compensation discussion and analysis section (CD&A) explaining the reasons for compensation programs; (3) a requirement that all equity compensation reflect the company's financial statements; (4) increased disclosure of potential termination payments for NEOs; (5) a summary table and equity disclosure for directors that are similar to NEO's disclosure.[81]

Despite the similarities between the U.S. rules and the proposed amendments, there is some divergence.[82] Compared to SOX requirements, the Canadian requirements pertaining to auditing committees are significantly different. First, the committee does not have to contain a financial expert, but the committee must disclose "the education and experience of all committee members

---

75. *Id.*

76. *Canadian Securities Regulators Propose New Rules for Executive Compensation Disclosure*, http://www.zsa.ca/zsa.php?fuseaction=main.featured_articles_item&id=537 (Apr. 10, 2007) [hereinafter *Executive Compensation*]. According to the CSA, a 2002 "study found that 95% of the companies disclosed compensation information in boilerplate language or general terms." *See* 6.2.2 COST BENEFIT ANALYSIS – EXECUTIVE COMPENSATION DISCLOSURE – AMENDMENTS TO NI 51-102 CONTINUOUS DISCLOSURE OBLIGATIONS, *available at* http://www.osc.gov.on.ca/Regulation/Rulemaking/Current/Part5/rule_20070329_51-102_cost-ben-analysis.pdf (last checked Jun. 26, 2007) [hereinafter AMENDMENT 6.2.2].

77. *Id.*

78. *Id.*

79. AMENDMENT 6.2.2, *supra* note 76.

80. *Executive Compensation, supra* note 67; Beck, *supra* note 76, at 60.

81. *Executive Compensation, supra* note 76.

82. *Id.* (the new rules, however, would recognize disclosures made under the SEC rules, so long as the company would not be considered a foreign private issuer under those rules).

. . . ."[83] Second, "[a]udit committees are not required to hire and fire the independent auditors as they are under SOX, because Canadian corporate law vests this power in the shareholders."[84] For the most part, the Canadian amendments are attempting to reflect Canada's principle-based regulatory system, as opposed to the U.S. rule-based system.[85] Proponents claim that the Canadian amendments will be clearer and simpler than the U.S. version.[86]

If the amendments are passed, there would be "significant changes in disclosure and compensation-setting practices in Canada."[87] Currently, the changes would begin in 2008 and apply to proxy statements for the 2007 fiscal year.[88] There are four highlights to the new rules. First, the summary compensation table would reflect total compensation.[89] Second, "[t]he 'named executive officers' (NEOs) would be determined by total compensation, rather than just salary bonus."[90] Third, more analysis regarding compensation would be required.[91] Finally, there will need to be more disclosure about termination compensation.[92]

VI. ONE SIZE DOESN'T FIT ALL

A. *European Union*

The European Economic Community (EEC) is "the most active and influential organization in the . . . field of international securities regulation."[93] In addition, the European Union (EU)

---

83. Beck, *supra* note 67 at 60.

84. *Id.* ("Instead, the audit committee will make a recommendation to the board about the auditor who will be proposed to the shareholders," but any rejection of the recommendation by the board must be disclosed).

85. *Id.*

86. *Id.*

87. *Id.*

88. *Id.*

89. *Id.*

90. *Id.*

91. *Id.* (The new analysis would require: "[D]iscussion and analysis of the material factors underlying compensation policies and decisions reflected in the data presented in the tables. . .[including] (i) how the compensation levels for the period might have been different under the various performance scenarios, and (ii) what compensation levels for future periods might be expected under various performance scenarios." Essentially, the Compensation Discussion and Analysis (CD&A) would reflect the heightened requirements of a Management Discussion and Analysis (MD&A)).

92. *Id.* (under the new amendments any materials terms and data for various termination scenarios would need to be provided).

93. 10C INTERNATIONAL CAPITAL MARKETS AND SECURITIES REGULATION § 50:1 (Harold S. Bloomenthal & Samuel Wolf eds., 2007) (the EEC is the only "multinational securities regime").

has continuously pursued a system that promotes uniform safeguards and greater access to the various exchanges of the member states.[94] Since the adoption of the Sixth Directive in 1980, the EU has established minimum principles for securities regulation in Europe.[95] These principles were based on "the International Disclosure Standards promulgated by the International Organization of Securities Commissions (IOSCO) in 1998."[96] For the most part, however, EU directives are "soft" regulations that allow member states to establish more specific regulatory regimes.

European Council Directive 2003/71/EC[97] – "revised prospectus directive" or RPD – allows issuers from member states to "make an offering or apply for a listing on the basis of the same prospectus throughout the European Union, without further authorization for the host country regulator (the "single passport" procedure[98])."[99] In addition, the directive strengthens disclosure requirements and clarifies the definition of qualified investors.[100]

> Among the features of the new system are the following: (1) the prospectus would be based upon IOSCO's International Disclosure Standards (for purposes of the RPD, a "prospectus" serves as both a prospectus for a public offering and listing particulars for a listing; these are essentially one and the same document, though the disclosure may vary somewhat based upon whether a public offering, listing, or both are contemplated); (2) issuers would be entitled to use a registration system similar to the U.S. shelf registration; by virtues of this system, issuers would have the possibility of effective an offering or a listing "on the basis of a simple notification of the prospectus approved by the home competent authority"; (3) the host state would have diminished power to influence the disclosure docu-

94. 10 INTERNATIONAL CAPITAL MARKETS AND SECURITIES REGULATION § 1:41 (Harold S. Bloomenthal & Samuel Wolf eds., 2007).

95. *Id.* (the Sixth Directive, which dealt with prospectuses, was adopted on March 17, 1980).

96. Bloomenthal & Wolf, *supra* note 93, § 50:1 (the directive, however, did not adopt the IOSCO standards in their entirety).

97. Council Directive 2003/71, 2003 O.J. (L 124) 64 (EC).

98. The single passport system allows "an investment services firm or professional licensed in a particular European Union country to operate within the other EU countries." *Supra* note 94, § 1:16.

99. AUTORITE DES MARCHES FINANCIERS, FRENCH REGULATION IN EUROPE'S FUTURE FINANCIAL LANDSCAPE 6 (Mar. 2006), *available at* http://www.amf-france.org/documents/general/6357_1.pdf [hereinafter AMF REPORT ON FRENCH REGULATION]. The European Central Bank endorsed the new directive, stating that it would simply compliance and harmonize and enhance disclose standards.

100. *Id.*

> ment; (4) the disclosure documents (except a summary) would not necessarily have to be translated into the language of the host county; (5) the provisions governing recognition of prospectuses from issuers outside the EU would be changed, potentially increasing the possibility for recognition of prospectuses form outside the EU, provided they are prepared in accordance with IOSCO standards; (6) issuers will be entitled to use incorporation by reference; (7) the prospectus must be publicly available in electronic form; and (8) the existing Prospectus Directive and Listing Particulars Directive would be repealed.[101]

Some of the highlights of the prospectus directive include: harmonization of prospectus content and approval times; stricter disclosure requirements for listed companies; flexible procedures for frequent issuers; electronic publication of prospectuses; and single passport system.[102] Another major component of the directive is incorporation by reference, which allows references to previously approved documents.[103]

After the EU Parliament and Council adopted Directive 2003/71/EC, the European Commission (EC) published Regulation No. 809/2004[104] implementing the directive. The regulation acknowledges the principles created in the prospectus directive and supplemented the principles with practical rules. The regulation established six requirements: (1) the format of prospectus; (2) the minimum information requirements to be included in a prospectus; (3) the method of publication; (4) the protocols according to which information can be incorporated by reference in a prospectus; (5) the publication methods of a prospectus; (6) the methods of dissemination of advertisements.[105]

In addition to prospectus disclosure, the EU has promoted regional convergence of national corporate governance standards.[106] On December 14, 2004 the EC recommended that member states require regulated companies to disclose their policies on executive compensation and prepare guidelines for disclosure and

101. Bloomenthal & Wolf, *supra* note 93, § 50:6.

102. AMF REPORT ON FRENCH REGULATION, *supra* note 99, at 17.

103. *Id.* at 18.

104. Commission Regulation 809/2004, 2004 O.J. (L 149) 1 (EC).

105. *Id.* at Art. 1.

106. AUTORITE DES MARCHES FINANCIERS, AMF 2006 REPORT ON CORPORATE GOVERNANCE AND INTERNAL CONTROL 11 (Jan. 22, 2007), *available at* http://www.amf-france.org/documents/general/7670_1.pdf [hereinafter AMF 2006 CORPORATE GOVERNANCE REPORT].

shareholder control.[107] In October, 2004, the EC began discussing amendments to the 4th and 7th Directives. In particular, the EU was proposing "to require companies to produce an annual report on corporate governance and internal control systems, and to increase transparency with respect to related parties' transactions and the use of special purpose vehicles."[108] The proposal is intended to increase disclosure and transparency in an effort to prevent corporate fraud.[109] In particular, the proposal had two recommendations in regards to corporate governance. First, "increase transparency of transaction involving related parties and off-balance sheet liabilities . . . ."[110] Second, require "annual corporate governance report[s] on all of the key elements in corporate governance structures and practices . . . ."[111]

A year after the prospectus directive, the EU passed Directive 2004/109/EC – a "transparency directive" designed to supplement the prospectus directive and other legislation.[112] The directive addresses annual and interim reporting obligations for regulated companies and establishes three primary reports; although home Member States my tack on additional requirements.[113] The directive applies to companies listed on an exchange in any member state, except issuers of only debt securities.[114]

The primary reports include annual, half-yearly, and quarterly statements. First, reporting companies must file their annual financial report within four months of the end of the financial year.[115] Second, a half-year report must be published within two months of the half year point.[116] Finally, there is also a third

---

107. AMF REPORT ON FRENCH REGULATION, *supra* note 99, at 47.

108. Id. at 9.

109. *Id.* at 54.

110. *Id.*

111. *Id.*

112. *Id.* at 21.

113. *Id.* For member states the directive was required to become national law by January 20, 2007. Bloomenthal & Wolf, *supra* note 47, § 50:7:30.

114. Bloomenthal & Wolf, *supra* note 47, § 50:7:30.

115. *Id.* "The annual financial reports are to include audited financial statements, a "management report," and a type of certification by "persons responsible within the issuer" to the effect that the financial statements give a real and fair view of the financial position and results of the issuer and that the management report includes a fair reviews of the businesses and position of the issuer, together with he principal risks and uncertainties they face."

116. *Id.* The "half-yearly" report "must include a condensed set of financial statements, an update of the management report, and like the annual report, a certification made by persons responsible within the issuer." (internal quotations omitted). Audit reports are required only if an audit has been conducted. In addition, "[t]he interim management report must include at least an indication of material

interim report that must be published between ten and twenty weeks following the annual or half-year report.[117] The directive also mandates immediate disclosure of certain information, including changes in shareholder rights and new issues.[118] All reports must be filed in the home member state and the member states are required to ensure that disclosed information is readily available.[119]

Currently, the EU is considering legislation that would create a single system of financial disclosure and passport for European securities.[120] The proposed system will apply to both debt and equity securities.[121] In addition to creating a single European security market, the EU is also proposing to "harmonise periodic and ongoing disclosure requirements for companies listed on regulated markets as well as the notification obligations for major shareholdings."[122]

B. *France*

In recent years France has actively reformed its securities regulation.[123] The reforms have made the French market more competitive at the international level.[124] Unlike the U.S., France has "refined and, in some instances, relaxed [some regulations]."[125] The *Loi de Modernisation des Activites Financieres* (Financial Activities Modernization Act) merged "the *Conseil des Bourses de Valeurs* (CBV), the French stock exchange authority, and *Counseil du Marche a Terme* (CMT), the futures market authority," into the *Conseil des Marches Financiers* (CMF).[126] Additional reforms include the *Loi de Securite Financiere* (Financial Security Law) of August 2003, the *Ordonnance portent reforme du regime des*

events that occurred during the period and their impact on the financial statements. . . [and] principal risks for the remaining 6 months of the financial year."

117. *Id.* These reports are not "quarterly reports" in the traditional sense. Instead, they are public statements that are made only if an "issuer has shares admitted to trading on a regulated market. . . ." The statements must include "an explanation of material events transpiring during the relevant period, and a general description of the financial position and performance of the issuer and its controlled undertakings during the relevant period." (internal quotations omitted).

118. *Id.*

119. *Id.*

120. AMF REPORT ON FRENCH REGULATION, *supra* note 99, at 6.

121. *Id.*

122. *Id.*

123. Bloomenthal & Wolf, *supra* note 47, § 1:15.

124. *Id.*

125. *Id.*

126. *Id.* at § 1:17. The act was passed on July 2, 1996.

valeurs mobilieres emises par les societes commerciales (Ordinance on Securities issued by commercial corporations) of June 2004, and the *Reglement General de l'Autorite des Marches Financiers* (General Regulation of the French Financial Market) which is produced by the *Autorite Des Marches Financiers'* (Financial Market Authority or "AMF").[127] Today, the AMF is the "new regulating and supervising body of the French financial market."[128]

France's disclosure requirements are found in the Monetary and Financial Code, the Commercial Code, and the AMF General Regulation.[129] Under "Article L.621-18-3 of the Monetary and Financial Code, listed companies are required to disclose information relating to the matters stipulated in the last paragraphs of Articles 225-37 and 225-68 of the Commercial Code, in accordance with the requirements of the AMF General Regulation."[130] The relevant articles of the Commercial Code require an annual "chairman's report."

A chairman's report is required by all companies regardless of their registration status.[131] Registered companies must comply with Article 221-8 of the AMF General Regulation.[132] For companies that are not registered but are covered by Article L. 621-18-3 of the Monetary and Financial Code, the chairman's report must provide information equivalent to registered company reports.[133] Finally, if a company is not registered or covered by the Monetary and Financial Code, then the report must be published in a separate document that complies with Article 221-7 of the AMF General Regulation.[134] In addition to the chairman's report, Article L. 225-235 of the Commercial Code mandates publication of a statutory auditors report commenting on the chairman's report and discussing "internal control procedures relating to the preparation and processing of accounting and financial information."[135]

France also has a law that requires periodic financial reports,

---

127. Bloomenthal & Wolf, *supra* note 47, §38:1.

128. *Id.* "The AMF was created by the Financial Security Act of August [1], 2003 [and merged] the *Commission des Operations de Bourse* (C.O.B.), the *Conseil des Marches Financiere* (C.M.F.), and the *Conseil de Discipline de la Gestion* (C.D.G.F.)". *Id.* at § 38:2.

129. AMF 2006 CORPORATE GOVERNANCE REPORT, *supra* note 106, at 5.

130. *Id.*

131. Id. at 4.

132. *Id.* The regulation requires that a registered company must include the reports and disclosure mentioned in Article 221-6 of the AMF General Regulation.

133. *Id.*

134. *Id.*

135. *Id.* at 5.

whose requirements vary depending on the size and status (i.e. public or private) of the company.[136] Unique rules apply for foreign companies listed on France's exchanges. The minimum requirements, as mandated by the AMF, include: "(a) the date and place of shareholders' meetings and (b) announcements regarding declaration and payment of dividends, new share issuance, and transaction involving the subscription attribution, withdrawal or conversion of shares [and (c)] financial information accompanied by a management report with translation."[137]

Both annual and semi-annual reports must be published.[138] In addition, the AMF also requires that any material information be published as soon as possible.[139] Companies are required to update their information if plans or intentions change and the effect will be material.[140] For purposes of unexpected material events, disclosure is satisfied if the information is presented "through a press release to a major news source" and a copy of the press release is sent to the AMF before the information is published.[141]

As a member state, France has complied with EU Directives as reflected in their domestic commercial code. Articles L.225-102-1 requires that all forms of executive compensation be disclosed in the company's annual report.[142] The "report must list the names and individual amounts of compensation and benefits of all kinds paid to each director and corporate officer during the year by the company, the companies that it controls or that control it."[143] Essentially, all methods of executive compensation, whether fixed, variable, or exceptional, must be detailed in the report.[144]

The AMF has consistently held that compliance with corporate governance should be flexible. For instance, a report must disclose any future "remuneration components," which may arise under any change in circumstances.[145] Flexibility, however,

136. Bloomenthal & Wolfe, *supra* note 47, § 38.24.
137. *Id.* at § 38.26 (citing COB Reg. 88-04).
138. *Id.*
139. *Id.* at § 38:27.
140. *Id.*
141. *Id.* If the company maintains and internet site they are required to post the information on their webpage.
142. AMF 2006 CORPORATE GOVERNANCE REPORT, *supra* note 106, at 5.
143. *Id.*
144. *Id.*
145. *Id.* The AMF estimates that "one third of the companies do not disclose severance benefits or supplementary retirement benefits for corporate officers." *Id.* at 18.

should not impair the clarity of the disclosure.[146] In addition, methods of calculation must be included in every detail for all forms of compensation, but there is no precise formula that must be used.[147] Prior to this requirement, it was estimated that most companies disclosed compensation amounts, but not their calculation methods.[148]

In addition to substantive requirements, the AMF also requires that communication between companies, the AMF, and the general public be open and available. Under "Article L. 621-18-3 of the Monetary and Financial Code, the AMF General Regulation" requires that executive compensation reports be available free of charge to the public and posted electronically.[149] For U.S.-based companies, the AMF recommends that they provide information regarding measures complying with the Sarbanes-Oxley Act.[150] Like U.S.-based companies, registered French companies must disclose executive compensation. Unlike the U.S., however, while most French companies separate the variable and fixed components of compensation packages, most do not disclose the evaluation method.[151]

C. *Germany*

Since the Treaty of Maastricht,[152] German securities markets have been the bench mark of the European Union.[153] Because Germany has the largest economy in the EU, "its capital markets are playing a leading role" in the Union.[154] Germany's two primary security statutes are the *Borsengesetz* (Stock Exchange Code) and *Aktiengesetz* (Stock Corporation Act or the "AktG").[155] Both statutes have undergone substantial revisions since the 1970s.[156] The *Viertes Finanzmarketforderungsgesetz* (BGBlI) of 2002 is the most recent and expansive modification of Germany's

146. *Id.* at 25.

147. *Id.* at 5. The AMF encourages full disclosure of "exact fixed and variable components of compensation . . . to avoid any ambiguity about executive pay and benefits." *Id.* at 18.

148. *Id.* at 17.

149. *Id.* at 6.

150. *Id.* This is particularly true if the U.S. standards are different from French requirements.

151. *Id.* at 17.

152. Treaty on European Union C 310/01, 2004 O.J. (EU).

153. Bloomenthal & Wolf, *supra* note 47, § 43:1.

154. *Id.*

155. *Id.*

156. *Id.*

securities laws.[157]

Like Canada, Germany's securities markets are not controlled by a centralized regulator.[158] Each of Germany's eight stock exchanges is independent and subject to local and federal regulation.[159] Germany has a three-tier, fragmented system of securities regulation.[160] Tier one is the federal agency *Bundesanstalt fur Finanzedienstleistungsaufsicht* (BAFin).[161] Tier two consists of the regional securities regulators.[162] Finally, tier three is comprised of various self-regulatory bodies, primarily "the eight German stock exchanges."[163]

The Stock Corporation Act, also known as the "AktG", requires companies listed on a German stock exchange to publish an annual report in the *Bundesanzeiger* (Federal Gazette).[164] In addition, Section 7 of the German Corporate Governance Code outlines the corporate disclosure requirements.[165] Registered companies must submit both annual and interim reports that comply with recognized international standards and national regulations under the German Commercial Code.[166] "The Consolidated Financial Statements *shall* be publicly accessible within 90 days of the end of the financial year; interim reports *shall* be publicly accessible within 45 days of the end of the reporting period."[167] In order to promote flexibility, the Code allows for deviations so long as they are disclosed.[168]

The aim of the Corporate Governance Code is to promote transparency, clarity and investor trust.[169] Following the EU directives on corporate governance, Germany revised the Code on June 12, 2006. All of the disclosure requirements must be included in the compensation section of the Corporate Governance

---

157. *Id.*

158. *Id.* at § 43:3.

159. Bloomenthal & Wolf, *supra* note 94, § 1:14 (the eight stock exchanges are located in Berlin, Bremen, Dusseldorf, Frankfort, Hamburg, Hannover, Munich, and Stuttgart).

160. Bloomenthal & Wolf, *supra* note 127, § 43:3.

161. *Id.*

162. *Id.*

163. *Id.*

164. *Id.* at § 43:65.

165. GOVERNMENT COMMISSION, GERMAN CORPORATE GOVERNANCE CODE 13 (Jun. 12, 2006), *available at* http://www.corporate-governance-code.de/eng/download/E_CorGov_Endfassung_June_2006.pdf [hereinafter GERMAN CG CODE].

166. *Id.*

167. *Id.* (emphasis added).

168. *Id.* at 2.

169. *Id.* at 1.

Report.[170] German companies must also disclose the variable and fixed elements of compensation packages.

Some of the primary revisions deal with executive compensation including one section which requires "[t]he total compensation of management board members [including] the monetary compensation elements, pension awards, other awards, especially in the event of termination of activity, fringe benefits of all kinds and benefits by third parties which were promised or granted in the fiscal year with regard to management board work."[171] In addition, all stock option plans, pension funds or liabilities, and comparable schemes must be included in the report.[172] Finally, severance packages and the nature of fringe benefits must be disclosed.[173]

D. Luxembourg

In Luxembourg, the Minister of Finance has significant impact on the regulation of Luxembourg's securities market.[174] The minister is directly involved in the domestic bond market, has enforcement authority of disclosure statements and appoints commissars "to the Luxembourg Stock Exchange (LSE) and to the *Institut Monetaire Luxembourgeois*."[175] Any enforcement action taken by the minister, however, is reviewable by the *Conseil d'Etat, Comite du contentieux* (Council of State).[176] In addition to the Minister of Finance, the *Institut Monetaire Luxembourgeois*, which was established on May 20, 1983, exercises regulatory authority over certain areas of Luxembourg's securities market.[177] The *Institut Monetaire* has the authority to regulate the public issuance of securities, including banks, investment funds and securities depositories.[178] One of the institute's primary roles it to supervise the disclosure statements of public companies.[179]

In addition to government regulators, the Luxembourg Stock Exchange has ten principles of corporate governance, with two of

170. *Id.* at 7.
171. *Id.*
172. *Id.*
173. *Id.* at 8.
174. Bloomenthal & Wolf, *supra* note 127, § 42:1.
175. *Id.*
176. *Id.* (citing Grand Ducal Regulation Annex 2 (Nov. 27, 1984)).
177. *Id.* at § 42:2 (The Institute replaced the *Commisaire au controle des banques* and retained all of the commission's previous regulatory authority.).
178. *Id.*
179. *Id.*

them addressing corporate disclosure.[180] Principle 1 addresses corporate governance framework and Principle 9 addresses financial reporting, internal control and risk management.[181] These principles followed the EU's lead in creating flexible corporate governance standards.[182] In fact, "[t]he main objective of the Ten Principles of Corporate Governance is to contribute to the creation of long-term value."[183] In addition, the Principles recognize that transparency is a necessary element of external control.[184] The Principles promote transparency through the Corporate Governance Charter "and the Corporate Governance Chapter in the annual report."[185]

Principle 1, Corporate Governance Framework, requires companies to "adopt a clear and transparent corporate governance framework for which it will provide adequate disclosure."[186] Recommendation 1.7 requires annual reports to contain a Corporate Governance Chapter and include specific items.[187] A company may deviate from the items, but they must explain their rationale.[188] Principle 9 is more focused and addresses financial reporting, internal control and risk management.[189] According to the Principle, a company should "establish strict rules, designed to protect the company's interest . . . ."[190] The Principle then establishes a list of recommendations pertaining to audit committee action and other internal controls.[191]

---

180. BOURSE DE LUXEMBOURG, CORPORATE GOVERNANCE: THE TEN PRINCIPLES OF CORPORATE GOVERNANCE OF THE LUXEMBOURG STOCK EXCHANGE (Apr. 2006), *available at* http://www.ecgi.org/codes/documents/luxembourg_en.pdf (The ten principles are (1) Corporate governance Framework, (2) Duties of the board, (3) Composition of the board and the special committees, (4) Appointment of directors and executive managers, (5) Conflicts of interest, (6) Evaluation of the performance of the board, (7) Management structure, (8) Remuneration policy, (9) Financial reporting, internal control and risk management, (10) Shareholders).

181. *Id.*

182. *Id.* at 1.

183. *Id.* at 5.

184. *Id.* at 7.

185. *Id.* at 8 ("The Corporate Governance Chapter of the annual report should include more factual information on the governance of the company, including any changes that have been implemented, together with the relevant events that took place during the last financial year, such as the appointment of new directors, the appointment of committee members and the annual remuneration of members of the board").

186. *Id.* at 13.

187. *Id.*

188. *Id.*

189. *Id.* at 25.

190. *Id.*

191. *Id.*

Principle 8, Remuneration Policy, states "[t]he company will secure the services of good quality directors and executive managers by means of a suitable remuneration policy that is compatible with the long-term interests of the company."[192] The principle also recommends that non-executive directors receive packages that reflect their responsibilities and commitment, but suggests that such directors not receive bonuses, long-term inventive or pensions plans, or any performance based compensation.[193] The LSE also suggests that boards establish transparent disclosure procedures and recommends that any stock option awards be approved in advance by shareholders resolution at an annual shareholder meeting.[194] In addition, the LSE recommends that all discounted stock options be disclosed and that all compensation awards be included in the company's Corporate Governance Charter.[195] Finally, the principle recommends that "[t]he total amount of direct and indirect remuneration received by directors and executive managers by virtue of their position should be disclosed in the annual report . . . [including] the fixed and the variable components . . . [and] the number of options granted . . . and the conditions of their exercise."[196]

E. United Kingdom

Prior to 2000, U.K. stock markets were regulated by multiple entities: (1) the FSA; the self-regulating organizations which consist of (2) the Personal Investment Authority, (3) the Investment Management Regulatory Organization, and (4) the Securities and Futures Authority; (5) the Supervision and Surveillance Branch of the Bank of England; (6) the Building Societies Commission; (7) the Insurance Directorate of the Treasury; and (8) the Registry of Friendly Societies.[197] The Financial Services and Markets Act of 2000 "replace[d] the fragmented structure of the financial service regulation in the United Kingdom" by making the FSA king.[198]

Like many European countries, the U.K. adheres to principle-based regulation. Under the Combined Code on Corporate Governance, a company's main principle is to "present a balanced and understandable assessment of the company's position and pros-

192. *Id.* at 23.
193. *Id.* at 24.
194. *Id.*
195. *Id.*
196. *Id.*
197. Bloomenthal & Wolf, *supra* note 94, § 1:41.
198. *Id.*

pects."[199] Under the Financial Services Act of 1986, listed companies must provide all information "that an investor and their professional adviers [*sic*] would reasonably requires and expect for the purpose of making an informed assessment."[200] When a listed company publishes its annual report, it must include a section explaining how it applied the principles and whether or not it complied with all sections of the Code.[201] If a company does not comply with all sections of the Code, it must list the sections that were not followed and the rationale for not following them.[202] In addition, the code lists sixteen other requirements that must be included in the annual report.[203]

On a final note, the Corporate Governance Code in the U.K. is significantly smaller than the U.S. code. In fact, the U.K. code is only fourteen pages long, as opposed to the U.S. version which contains sixty-six pages excluding SEC rules.[204] The difference in complexity is due to a number of factors, primarily the conflict between the U.S. rule-based system and the principle-based system followed by most developed nations.

Like the Luxembourg principles, the main principle for the level and make-up of remuneration states:

> Levels of remuneration should be sufficient to attract, retain and motivate directors of the quality required to run the company successfully, but a company should avoid paying more than is necessary for this purpose. A significant proportion of executive directors' remuneration should be structured so as to link rewards to corporate and individual performance.[205]

The first main principle's support for performance based compensation is based on the assumption that such awards will align the directors' interest with those of the shareholder.[206] In order to maintain the alignment, the Code requires that stock options are not discounted unless "permitted by the relevant provisions of the

---

199. FINANCIAL REPORTING COUNCIL, THE COMBINED CODE ON CORPORATE GOVERNANCE 14 (Jun. 2006), *available at* http://www.frc.org.uk/documents/pagemanager/frc/Combined%20code%20June%/202006.pdf [hereinafter U.K. COMBINED CODE].

200. Bloomenthal & Wolf, *supra* note 94, § 1:40 (citing 1986 FSA § 146).

201. U.K. COMBINED CODE, *supra* note 199, at 23.

202. *Id.*

203. *Id.* at 23-24.

204. Bloomenthal & Wolf, *supra* note 94, § 1:98.

205. U.K. COMBINED CODE, *supra* note 199, at 11.

206. *Id.*

Listing Rules."[207]

Again, the U.K. Combined Code is similar to the Luxembourg principles because both state that the "[l]evels of remuneration for non-executive directors should reflect the time commitment and responsibilities of the role."[208] The Code also states that non-executive directors should not receive stock options unless shareholder approval is obtained in advance.[209] In addition, the Code suggests that the options should be frozen for one year because holding the stock suggests the non-director's independence.[210]

The second main principle of remuneration demands a transparent procedure for developing and fixing executive compensation packages and clearly states that "[n]o director should be involved in deciding his or her own remuneration."[211] The code provisions regarding the principle push for independence and disclosure in regards to the actions and decisions of the compensation committee.[212]

F. United States

Unlike Europe and Canada, the U.S. focuses on a rule-based regulatory system. Under rule based systems, companies must follow specific form requirements when disclosing executive compensation. The result is a complex and formal system of disclosure that attempts to micromanage compliance. While rule-based systems are clearly defined and allow for more definitive compliance, there are frequent grey areas that leave companies wondering whether they are within the rules. Often, companies seek No-Action letters from the SEC in order to protect them from non-compliance, or at least alleviate their concerns. Ultimately, the lack of compliance flexibility makes the rule-based system less efficient and perhaps less effective.

While the Securities Act of 1933 requires certain disclosures to public offerings, the Security Exchange Act of 1934 "extends the disclosure approach to the trading markets by requiring current financial and other material information to be filed periodically by certain issuers of publicly traded securities."[213] Disclosure is

---

207. *Id.*
208. *Id.*
209. *Id.*
210. *Id.*
211. *Id.*
212. *Id.* at 13.
213. Bloomenthal and Wolf, *supra* note 94, § 2:8 (*citing* Securities Exchange Act of 1934 § 13, 15 U.S.C. § 78m (1970)).

meant to provide investors with the information necessary to make an informed decision.[214] Under the 1934 Exchange Act, companies listed on U.S. exchanges must provide continuous reports, "including an annual report on Form 10-K, a quarterly report on Form 10-Q, and periodic reports depending upon the occurrence of certain events on Form 8-K."[215]

Over the years, executive compensation in the U.S. has been the target of increased pressure from shareholders and institutional investors.[216] Compensation packages are increasingly complex, leaving shareholders progressively more suspicious.[217] Generally, corporate executives try to design their compensation packages in a way that would "minimize adverse shareholder reaction and circumvent pressures form the investment community."[218] However, the impact of recent backdating scandals in the U.S. created more than just adverse shareholder reaction; it forced the SEC to enact "the most significant overhaul of benefit disclosure policy since 1992."[219]

In July 2006, the SEC revised its rules for executive compensation. The purpose of the rule was "to make proxy and information statements, reports and registration statements easier to understand [and] provide investors with a clearer and more complete picture of the compensation earned by a company's [executives]."[220] The new rule "affect[ed] disclosure in proxy statements, annual reports and registration statements, as well as the current reporting of compensation arrangements."[221] On September 8, 2006, the SEC published its new rule regarding executive compensation disclosure.[222] The new rule contained a number of requirements including: (1) a single figure for total compensation for every named executive; (2) a plain English requirement; (3) revi-

214. *Id.*

215. *Id.* at § 1:37.

216. John D. Shipman, *The Future of Backdating Equity Options in the Wake of SEC Executive Compensation Disclosure Rules*, 85 N.C. L. Rev. 1194, 1194 (2007).

217. *See id.* (noting shareholder frustration in trying to precisely determine executive compensation amounts).

218. *Id.*

219. *Id.*

220. Executive Compensation and Related Person Disclosure, 71 Fed. Reg. 175, 53,158 (Sep. 8, 2006) (to be codified at 17 C.F.R. 228, 229, et al) [hereinafter Final Rule.]

221. SEC Press Release, *SEC Votes to Adopt Changes to Disclosure Requirements Concerning Executive Compensation and Related Matters* (Jul. 26, 2006), http://sec.gov/news/press/2006/2006-123.htm.

222. Final Rule, *supra* note 222, at 53.

sions to tabular disclosure[223]; and (4) a new Compensation Discussion and Analysis form.[224]

The new rule organizes executive compensation "into three broad categories: compensation over the last three years; holdings of outstanding equity-related interests received as compensation that are the source of future gains; and retirement plans, deferred compensation and other post-employment payments and benefits."[225] The disclosure will include a number of tables such as the Summary Compensation Table[226] which categorizes: (1) dollar value of all equity based awards; (2) amounts under non-equity incentive plans; (3) changes in pension benefits and deferred compensation packages; (4) aggregate amounts of all other compensation unless less than $10,000; and (5) total compensation.[227]

Additional tables include a Director Compensation Table, the Outstanding Equity Awards at Fiscal-Year End Table,[228] the Option Exercises and Stock Vested Table,[229] the Pension Benefits Table, the Nonqualified Deferred Compensation Table, and "[a] narrative description of any arrangement that provides for payments or benefits at, following, or in connection with" termination or change of control.[230]

The rule will also address recent abuses in options backdating. Companies will now be required to disclose information regarding options plans and practices.[231] Specific disclosure requirements include: [t]he grant date fair value; [t]he FAS 123R grant date; [t]the closing market price on the grant date if it is greater than the exercise price of the award; and [t]he date the

223. *Id.* "The amendments will refine the currently required tabular disclosure and combine it with improved narrative disclosure to elicit clearer and more complete disclosure of compensation of the principal executive officer, principal financial officer, the three other highest paid executive officers and the directors."

224. *Id.* This form will disclose the principal policies and decisions behind executive compensation program. The form will be filed with the SEC and available to the public. There will also be a Compensation Committee Report which may be included in the annual 10-K and proxy statement. Finally, the performance graph will be moved from executive compensation disclosure to annual shareholder reports.

225. *Id.*

226. *Id.* This table is "the principal disclosure vehicle for executive compensation, showing compensation for each named executive officer over the last three years." The table will also include a Grants of Plan-Base Awards Table, which explains the information contained in the summary table.

227. *Id.*

228. Showing "amounts realized on equity compensation during the last fiscal year." *Id.*

229. *Id.*

230. *Id.*

231. *Id.*

compensation committee or full board of directors took action to grant the award if that date is different than the grant date.[232] The company will also be required to answer numerous questions in the Compensation Discussion and Analysis section.[233]

After the rule was released, however, there was still considerable discussion about the completeness of the rule. As a result, the SEC passed an amendment on December 22, 2006.[234] The amendment "align[ed] the reporting of equity awards in the Summary Compensation Table and the Director Compensation Table to the amounts that are disclosed in the financial statements under FAS 123R."[235] The SEC stated that the amendment would make disclosure easier and more understandable to investors.[236]

Essentially, the interim rule "add[s] a column showing, on a[ ] grant-by-grant basis, the full grant date fair value of awards" to the Grants of Plan-Based Awards Table (GPBA Table) which is included in the Summary Compensation Table and Director Compensation Table.[237] In addition, the GPBA Table must disclose information regarding a repricing or other material change to executive stock options.[238] The rule also conforms the timing of the disclosure to FAS 123R.[239]

As the rule now stands, all stock and option awards must "be reported in both the Summary Compensation Table and Director Compensation Table in an amount equal to the dollar amount recognized for financial statement reporting purposes for such

232. *Id.*

233. *Id.*

234. For more information on the amendment see SEC Interim Final Rule (December 22, 2006), http://www.sec.gov/rules/final/2006/33-8765.pdf.

235. SEC Press Release, *SEC Amends Executive Compensation Disclosure to More Closely Align With FAS 123R* (Dec. 22, 2006), http://www.sec.gov/news/press/2006/2006-219.htm. Financial Accounting Standards Share-Based Payment (FAS 123R) deals with the "reporting of stock and option awards." *Id.*

236. *Id.*

237. Executive Compensation Disclosure, 71 Fed. Reg. 250, 78,338 (Dec. 29, 2006). The initial rule required "the full value of options and stock awards. . .to be included in the Summary Compensation Table and Director Compensation Table in the year of grant." Donald P. Carleen et al., *SEC Amends New Executive Compensation Disclosure Rules, Effective Immediately*, 26 NO. 2 Banking & Fin. Srvs. Pol'y Rep. 1, 1 (2007). The rule ignored vesting and forfeiture conditions and award information. *Id.* The interim rule replaced "the full grant date fair value, the includible value relating to stock and options awards displaced in the Stock Awards and Options Awards columns" with FAS 123R requirements. *Id.* This standard required the exact dollar amount cost of the compensation to be recognized in the fiscal year. *Id.*

238. *Id.*

239. Carleen et al., *supra* note 237, at 1.

awards for the fiscal year in accordance with FAS 123R."[240] In sum, the executive compensation rules are largely an overhaul of equity awards, particularly options.[241] Companies must now disclose both process and rationale for all stock option awards.[242] Further, the disclosures must be "written in plain English so every investor can understand [them]" and must be clearly explained.[243]

According to Shipman, however, "the new executive compensation disclosure rule serves only as symbolic gesture, reinforcing existing federal securities laws that already mandate the disclosure of backdated options."[244] "Prior to the new executive compensation disclosure rules, the practice of issuing undisclosed backdated option grants was illegal and violated federal securities law."[245] Section 10(b) of the Exchange Act and Rules 12b-20, 13a-1, and 13a-11 all prohibited "misleading statements or omitting material information in their public disclosures."[246] Under these provisions, the Department of Justice (DOJ) was prosecuting misleading disclosure prior to the SEC's new rule.[247] Ultimately, both the SEC and DOJ were prosecuting misleading disclosures prior to the new rules and the new rules do not appear to enhance any of these provisions.[248]

The SEC, however, is not supposed to determine the best corporate practices and enforce such determinations on publicly-traded companies. Shipman correctly notes that "the SEC has explicitly elected to remain neutral on the subject" of equity options in executive compensation packages.[249] The SEC should remain neutral and allow corporations to determine how their

240. Victor M. Rosenzweig, *Quarterly Survey of SEC Rulemaking and Major Appellate Decisions*, 35 No. 1 SEC. REG. L. J. 5 (Spring 2007).

241. *Id.* at 1197.

242. *Id.*

243. *Id.* at 1209 (quoting Chairman Cox and citing Ted Allen & Subodh Mishra, Institutional S'holder Servs., An Investor Guide to the Stock Option Timing Scandal 1 (2006), *available at* http://www.issproxoy.com/pdf/OptionTiming.pdf) (internal quotations omitted).

244. *Id.* Shipman suggests that the SEC is "[t]acitly accept[ing] the legitimacy of these deceptive . . . practices" and calls for a blanket prohibition against stock option awards. *Id.* at 1197-98.

245. *Id.* at 1211 (citing M.P. Narayanan et al. *The Economic Impact of Backdating of Executive Stock Options*, 105 Mich. L. Rev. 1597, n.22 (2007)).

246. *Id.* at 1211-12.

247. *See id.* at 1213 (discussing the Justice Department's handling of options backdating cases).

248. *Id.* at 1213-14.

249. *Id.* at 1200.

compensation packages are structured. On the other hand, as illustrated in the SEC's recent activity in the area of executive compensation, the SEC should ensure that the decision a corporation makes is clearly presented to shareholders. The new rule promulgated by the SEC is a clear outline of what is and is not adequate disclosure.[250] The rule provides companies with guidance and shareholders with the ability to quickly and easily monitor corporate disclosures.[251]

In addition, the SEC should be monitoring the corporations to ensure that executive action is not manipulating markets or defrauding investors. While this end may be obtained by regulating the actual composition of compensation packages, the same result can be obtained by requiring clear, concise disclosure.

The only government body, if any, that should be deciding such regulation is Congress because executive compensation is influenced by corporate, tax, and securities law. Shipman correctly notes that the SEC has historically focused "on the disclosure of information as opposed to substantive rulemaking."[252] However, the intent and purposes of the SEC, the Securities Act, and the Exchange Act has always been ensuring that investors receive complete and accurate information so that *they* can make an informed decision. The SEC was never meant to be a legislature of corporate business practices. The Sarbanes-Oxley Act (SOX), which calls for substantive regulation in certain areas, was a mandate from Congress. The broad scope of SOX reflects the Congress' legislative role, not the SEC's regulatory role. The new SEC disclosure rules present an acceptable balance between corporate disclosure and decision making and controlled government regulation.

VII. CANADIAN RULES FOR A CANADIAN SYSTEM

Given the strong relationship and close proximity to the United States, there is some pressure for Canada to adopt a similar system of securities regulation. There is, however, a funda-

250. In fact, comments by SEC Commissioner Atkins suggested that the illegality of options backdating was, in part, related to the lack of clear guidelines in the area of executive compensation disclosure. *Id.* at 1215.

251. Although the rule adopts a principle-based approach to corporate disclosure, the terms of the rule provide specific provisions that must be satisfied or adequately described. Such an approach is more definitive than the prior rules which merely relied on misleading or inadequate disclosure.

252. *Id.* at 1219 (citing James Hamilton, *Executive Compensation and Related-Party Disclosure: SEC Rules and Explanation* 79 (2006)).

mental difference between the Canadian and U.S. systems. At its core, the Canadian system is based on flexible principles that can be adapted to meet the changing needs of Canada's business community. The U.S., on the other hand, has a complex rule-based system that is often overly formal and inefficient. In addition to a systemic foundational difference, proponents of the principle-based system argue that "since Canadian public companies are often less widely held and are smaller than U.S. companies (making compliance costs relatively more significant), more flexibility is appropriate."[253] Proponents of the rule-based U.S. system argue that their perspective is less lenient and prevents a conflict of interest between private, self-regulating exchanges and investors.[254] But a conflict of interest can be avoided by aligning interests, as opposed to requiring burdensome compliance.

Another reason that Canada should not try to mimic the U.S. system is structure. The U.S. system is dominated by a strong central regulator, the SEC. Canada, on the other hand, has a regional structure where each province or territory regulates the securities markets.[255] While there is a push to create "a uniform securities act" there is still internal resistance by the province of British Columbia and others.[256] Both British Columbia and Quebec are resistant to establishing a strong central regulator because they fear that regional concerns will not be addressed and the system will be dominated by Ontario.[257]

A road that Canada should consider would be the path paved by the European Union. Under the EU structure, a central regulator creates "soft" laws that are primarily principle based. These laws allow regional actors to slightly modify regulations to fit specific needs. A cooperative regulatory framework, similar to the EU, would allow Canada to maintain a minimum level of uniformity without completely sacrificing regional interests. In fact, the foundation for such an organization has already been laid by the CSA.

In regards to executive compensation, Canada should maintain its principle-based approach but with very clear requirements and consequences. The principles of transparency and disclosure should be central to Canadian corporate governance. The require-

253. Beck, *supra* note 67, at 62.
254. *Id.*
255. *Id.*
256. *Id.*
257. *Id.*

ments should include: (1) process disclosure; (2) a plain language requirement; (3) and promotion of performance based compensation that includes limited shareholder involvement.

In the context of executive compensation, disclosure and transparency should include the end result and the process.[258] Process disclosure allows shareholders and regulators to understand changes in expected compensation packages.[259] "Disclosure of the process will further ensure that all involved will be diligent in their efforts and accountable for the outcome."[260] Ultimately, the disclosure process allows shareholders to police the company and creates a disincentive for executives to engage in manipulative practices. Compensation committees will be forced to explain not only their actions, but the rationale behind such actions. Further, disclosure of process might lead to more uniformity throughout the entire industry, which will allow the entire investor community to check the abuse of executive authority.

Performance based compensation, while not fool-proof, is still the most effective means of acquiring, retaining and motivating corporate executives. Performance based compensation is only effective, however, if the process is transparent. Requiring disclosure of the process and rationale will help to prevent executive abuse of performance based awards. Ultimately, a transparent performance based package will align shareholder and executive interests and allow both government regulators and shareholders to oversee the compensation process. In addition, Canadian regulators should encourage limited shareholder involvement performance base packages. Shareholders should be given the opportunity to approve certain performance based awards, primarily options. Allowing shareholders to approve options, especially those that will be discounted or back-dated, will help to prevent corporate fraud because shareholders will not want their shares diluted or the company harmed by corporate scandal.

Canada's approach should balance principles with clear guidelines. The guidelines should not be mandatory but expected, unless there is a complete and clear rationale for deviation. Because Canadian securities regulation has long been fragmented, Canada should consider establishing a nationwide organization that promulgates broad principles and guidelines. This

258. *See* ICD REPORT, *supra* note 1, at 41 (noting that disclosure needs to include disclosure of process to be effective).

259. *Id.*

260. *Id.* at 42.

approach would bring a minimum level of guaranteed uniformity, but still allow for regional regulators to tailor regulation to local needs. Finally, any action should be sensitive to the business environment. Strict regulation of executive compensation should be avoided because it will obstruct creativity and competitiveness within the marketplace. In addition, regulators need to ensure that deterrent mechanisms are punishing violators and not shareholders. As a result, any civil penalties should be targeted at the offender and not necessarily the company. Further, a balance of strong civil and criminal penalties will be more effective than relying on moderate civil penalties and distant criminal sanctions. Any concern regarding overzealous criminal sanctions could be alleviated by developing a principle-based regulatory system that allows for flexibility.