



Understanding Canada's Regulatory Landscape

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SESSION OUTLINE

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- BUSINESS VEHICLES
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- LEGAL RULES GOVERNING EQUITY INCENTIVE PLANS
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 - Canada stock exchange rules
 - Privacy law rules
 - Special tax incentives
- CANADIAN TAX TREATMENT
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INTRODUCTION



- **Canadian newspapers loudly announce:**
 - stock option windfalls for CEOs
 - the decline in popularity of the option approach to compensation
 - how far ahead of the USA Canadian accounting approaches are for stock options
 - how Canadian companies are leading the way with performance based equity plans
 - is Canada really in the forefront of equity based compensation plans
 - what are the general considerations that multinational corporates should consider in establishing an equity compensation plan in Canada

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THE CANADIAN FEDERAL SYSTEM

- a Federation of the Federal government, the provinces and territories under federal jurisdiction
- executive, legislature and judiciary
- Queen Elizabeth II, head of state
- Constitution Act, Charter of Rights and division of legislative powers
- provincial powers: direct taxation, incorporations, property and civil rights, administration of justice within the province
- federal heads of powers: taxation by any mode, trade and commerce, currency, banking, criminal law

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THE CANADIAN FEDERAL SYSTEM (continued)

- federal and provincial governments delegation of law making power to junior government levels or public authorities
- municipal councils of cities and towns
- regulatory agencies, boards and commissions
- Business in Canada subject to laws at federal, provincial and municipal levels:
 - general application laws: taxation, criminal, competition
 - particular sectors of economy: securities, mining industries

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BUSINESS VEHICLES

- organization of business in Canada reflects Canada's common law heritage and, for most part, Canadian business vehicles are like those found in most western countries
- most significant form of business enterprise is the corporation
- business corporation is a legal entity separate and apart from its directors, officers and shareholders and has its own individual legal status
- federal government and all provincial governments have enacted legislation relating to business corporations

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BUSINESS VEHICLES
(continued)

- to all intents and purposes, federal and provincial business corporations are essentially the same, however, many foreign investors consider there is a perceived prestige associated with a corporation created under federal laws, but provincial companies have the same capacity as a federal corporation to transact their business across Canada and worldwide
- a provincial corporation may carry on business in the province of incorporation and in other provinces provided there is compliance with applicable registration or licensing requirements of those other provinces

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BUSINESS VEHICLES
(continued)

- a federal corporation has the right to conduct business in any province, subject to provincial laws of general application to all corporations doing business in such province, such as filing corporate returns and paying fees
- foreign company registration and licensing rules are triggered in Canada if an employee is located here
- for income tax purposes, the income or loss of a business corporation is determined and taxed within the corporation; if it distributes is after-tax income to shareholders by way of dividends, the receipt of those dividends are, for the most part, taxed in the hands of the shareholders

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BUSINESS VEHICLES
(continued)

- any losses incurred by the business corporation belong to it and cannot be utilized by the shareholders against their income for tax purposes

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SHARE PLANS - Overview

- Variety of plans exist in Canada
- Few applicable corporate law requirements related to establishment of share plans
- If the corporate issuer is listed on one of the Canada stock exchanges must be mindful of notice requirements
- There are exemptions available from the registration and prospectus requirements under provincial securities laws
- Canada's federal *Income Tax Act* has aligned corporate objectives and placed Canada on a taxation par with the USA
- Canada's accounting treatment of options places us ahead of the American practices, depends on your viewpoint

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CANADA – LEGAL RULES GOVERNING EQUITY INCENTIVE PLANS

- Securities regulatory rules
- Canada stock exchange rules
- Privacy law rules
- Special incentives

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SECURITIES REGULATORY RULES General Rules

- Securities are governed provincially, not federally, so compliance is required in each province where an option holder is located
- General Rules
 - 1) to trade in securities, seller must be registered, or trade through a broker that is registered, with securities regulatory authorities; and
 - 2) treasury issues or control block issues (shareholding greater than 20%) require receipt for a prospectus (disclosure document) from securities regulatory authorities



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SECURITIES REGULATORY RULES
General Rules (continued)

UNLESS

- 3) Statutory exemption; or
- 4) Discretionary exemptive relief provided by securities regulatory authorities on application

- **In a typical share compensation arrangement, concerned with 4 transactions:**
 - 1) issue of option – trade and distribution by issuer
 - 2) exercise of option – trade and distribution by issuer
 - 3) trade of option/share – trade by employee (if not a control block)
 - 4) if issuer buys back all or part of employee shares – issuer bid by issuer

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SECURITIES REGULATORY RULES
Multilateral Instrument 45-105 Exemption

- **Applicable in all Canada province except Quebec and New Brunswick**
- **Applies to issuer or an “affiliated” entity**
- **Includes current and former employees, officer/executives, contract consultants and directors (and their respective subsidiary entity, or tax deferred retirement plan (RRSP or RRIF)) and employee administrators (trustee, custodian or administrator acting for employees)**
- **Also extended to apply to employee spouses and spouses’ tax deferred retirement plan**
- **Participation must be voluntary – no expectation of employment or appointment or continued employment or appointment**

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SECURITIES REGULATORY RULES
(continued)

- **Exemption of issuer**
- **Exemption of option holder available if:**
 - 1) not a reporting issuer when option issued; and
 - 2) de minimis Canadian market when option issued (10% or less shares and shareholders); and
 - 3) trade executed outside of Canada or to a person or company outside Canada
- **Exemption of issuer from issuer bid requirements if:**
 - 1) Purpose of acquisition to fulfill withholding tax obligations or to pay for option exercise price; and
 - 2) Determination of value of securities acquired set out in plan; and
 - 3) Date of exercise of option chosen by option holder; and
 - 4) No more than an aggregate of 5% acquire by issue within prior 12 month period

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CANADIAN STOCK EXCHANGE REQUIREMENTS FOR SHARE COMPENSATION PLANS (continued)

- **TSX Venture Exchange (small cap)**
 - pre-clearance
 - different rules for Tier 1 (senior) and Tier 2 (junior) companies
 - maximum rolling 20%, fixed 20% with shareholder approval
 - can't issue more than 5% to one person (except for Tier 1 issuer with disinterested shareholder approval)
 - other rules similar to TSX

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PRIVACY LAW RULES

- **Effective January 1, 2004, applied to every private sector organization in Canada that collects, uses or discloses personal information in the course of a commercial activity**
- **Either PIPEDA (federal) or substantially similar provincial law**
- **Privacy obligations consist of**
 - accountability
 - identify purpose of collection
 - obtain consent to collect
 - limit use, disclosure and retention
 - accuracy
 - safeguards
 - openness
 - individual access
 - challenge compliance

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SPECIAL TAX INCENTIVES

- **No incentives similar to US or England**
- **Provincial incentive available in:**
 - B.C. – Employee Share Ownership Plan – employees get 20% tax credit on investment
 - Ontario – Specified Employee Ownership Corporation – employees get 20% on first \$3,500 and 30% on balance to \$15,000
 - Ontario – Ontario Research Employee Stock Option Credit (ORESCO) – employees involved in scientific research and experimental development at R&D intensive companies can receive a refund on up to \$100,000 of taxable income each year from taxable stock option benefits and taxable capital gains arising from stock options (granted after December 21, 2000)

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CANADIAN TAX TREATMENT

- **Corporation**
 - compensation settled with cash is deductible
 - “no” deduction for stock option expense
- **Employee**
 - cash compensation is fully taxable (top rate = 46%)
- **Stock option benefit**
 - 50% taxable if option price \geq FMV at grant date
 - exercise date = taxable event

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CANADIAN TAX TREATMENT (continued)

- **Shares held after exercise of option**
 - increase in value taxed as capital gain (50% taxable)
 - decline in value results in capital loss (can only be used to offset capital gains, not employment income)
- **Employee**
 - Pitfall: market fluctuations may trigger taxable benefit at top of market, followed by unusable capital loss if value declines

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EMPLOYMENT LAW ISSUES

- **If an employee is terminated, without cause, Canadian employment law dictates that such employee is entitled to reasonable notice of such termination or in the alternative, compensation instead of notice**
- **The Canadian approach is different from the US presumption of employment at will**
- **This issue of termination affects most equity plans in that vesting an exercise rights are tied into termination of employment issues**
- **The question becomes: when does “termination” occur. Especially so when termination is without cause and without notice**

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EMPLOYMENT LAW ISSUES
(continued)

- **The dispute may be focused as:**
 - Employer says termination is when employee is actually terminated
 - Employee's position is that termination occurs at the end of the period of reasonable notice
- **As a result, equity plan language is very important and Canadian courts recognize the importance of such contractual language. If it is too general, however, there may be sufficient room to interpret termination without lawful termination**

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EMPLOYMENT LAW ISSUES
(continued)

- **Solutions – Canadianize your plans:**
 - 1) If US plan, likely to contain this issue defect, therefore fix the flaw for future employee situations
 - 2) Specifically define the trigger dates
 - 3) Clear, concise language to avoid court interpretations

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CONCLUSION
CURRENT THINKING IN CANADA

- **Eliminate/limit number of options granted**
 - No tolerance for high share dilution
- **Vesting of options after minimum three-year period**
- **Replace option plans with direct stock ownership plans funded by employee loans**
- **Grant executives stock as part of their compensation, subject to mandated holding period**

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Any Questions?

Thank You

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