THE EQUITY INCENTIVE CANADIAN STARTUPS NEED (HINT: IT IS NOT STOCK OPTIONS)

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Growth companies contribute disproportionately to Canada's job creation, economic development and innovation. Most growth companies can match neither the salaries nor the security of more established competitors for executive talent. This makes their only advantage—the growth prospects of their equity—particularly important part of their compensation arrangements. Canadian growth companies (and Canadian businesses generally) make less use of equity incentives than their American peers and the kind of incentive they use almost exclusively, stock options, are strongly criticized by politicians, academics, institutional shareholders, and corporate governance experts.

Stock options are accused of contributing to income inequality and creating incentives for value-destroying behaviour in large established corporations, but it is not clear these critiques have much to do with their use by growth companies. As well, it is not clear why these companies should be restricted to the use of stock options as the only equity incentive scheme available to them without adverse tax effects. For example, there are good reasons American growth companies make extensive use of share grants. As Canada enters its fourth round of amendments in this century to the tax rules relating to equity incentives, it is time to consider a tax regime that begins to differentiate between growth companies and their larger, more established counterparts, and that ceases to differentiate between issuing an option to acquire shares and simply issuing shares.

Table of Contents

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INTRODUCTION

The fastest growing companies in Canada contribute disproportionately to the country's economic and employment growth.[1] They labour under many disadvantages, such as the much-discussed scarcity of institutional capital focused on the earliest stages of their development.[2] Some of the disadvantages faced by Canadian startups seem almost intractable, such as the small size of the Canadian market and the paucity of experienced executive talent outside the natural resource sector. This paper, however, is about a problem that is comparatively easy to fix: Canadian growth companies (and Canadian businesses generally) make less use of equity incentives than their American peers and the kind of incentive they use almost exclusively, stock options, are almost universally regarded as inferior. Stock options set up perverse managerial incentives, fail to operate at all in certain conditions such as the current down-market, and make it very difficult to attract badly-needed managerial talent, particularly if already employed in other countries.[3]

The explanation why Canadian startups continue to use an equity incentive that many of their executives, directors and investors regard as less than ideal, is connected to Canadian tax rules. The federal government is in the midst of its fourth attempt to reform the tax regime around stock options in less than twenty years.[4] It is difficult to think of any set of technical tax rules that has received such constant attention. Since the tax treatment of options was extensively revised in 2000, the importance of this form of equity to startups has occupied the center of the debate.[5]

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[1] See discussion at text accompanying notes 27–32 below.

[2] Industry Canada, *Growing the Businesses of Tomorrow: Challenges and Prospects of Early Stage Venture Capital Investment in Canada* by Macdonald & Associates Limited (Ottawa: Industry Canada, 2005) (showing that at the height of venture capital flows in Canada these amounted to less than half the amount provided to American peer companies at 28); Reuven Brenner & Gabrielle Brenner, "Venture Capital in Canada: Lessons for Building (or Restoring) National Wealth" (2010) 22:1 J Applied Corporate Finance 86 at 91 (suggesting venture capital investment in Canada is about one-quarter of what one would expect from looking at international comparators).

[3] See discussion at text accompanying notes 38–45 below.

[4] *Income Tax Act*, RSC 1985, c 1 (5th Supp) [*ITA*] as amended by *Income Tax Amendments Act, 2000*, SC 2001, c 17; *Jobs and Economic Growth Act,* SC 2010, c 12; *An Act to amend the Income Tax Act*, SC 2016, c 11; Canada Revenue Agency, News Release, "Minister of National Revenue releases fifth report in the tax gap series" (18 June 2019), online: *Government of Canada* <www.canada.ca/en/revenue-agency/news/2019/06/minister-of-national-revenue-releases-fifth-report-in-the-tax-gap-series.html>.

[5] See e.g. Sean Silcoff & Janet McFarland, "NDP's Stock Option Plan Would 'Kill' Canadian Startup Ecosystem, Tech Leaders Say", *The Globe and Mail* (24 September 2015), online: <www.theglobeandmail.com/report-on-business/small-business/startups/ndps-stock-option-plan-would-kill-canadian-startup-ecosystem-tech-leaders-say/article26526506/>. See also Amin Mawani, "Tax Deductibility of Employee Stock Options" (2003) 51:3 Can Tax J 1230 at 1248 (discussing the denial of tax deductions for employee stock options); Daniel Sandler, "The Tax Treatment of Employee Stock Options: Generous to a Fault" (2001) 49:2 Can Tax J 259 at 264 (arguing the Canadian tax treatment of options was more generous than that afforded by the United States and that money received from the exercise of options should be treated as ordinary income) [Sandler, "Tax Treatment of Employee Stock Options"].

But no one is asking: why stock options? Why should the government decide which compensation structures are used by startups?

I. THE DEBATES AROUND STOCK OPTIONS

Stock options provide their holder with the right to buy a certain number of shares at a price that is set at the time the option is granted. The number of shares that may be purchased vests over time and the option, itself, expires five to ten years after it is issued. Once vested and prior to its expiry, the holder of an option can pay the exercise price to acquire the shares. This is only done when the share price of the issuer has increased above the exercise price, and nearly always only when there is a liquid market for the underlying shares, because the option holder must sell some of the shares to cover the price of exercising the option and, as we will see, to pay the tax owing from exercising the option. The value of the option at the time of exercise is the difference between the exercise price and the then current market price.

There are two different debates about stock options in Canada: one involving the corporate governance of large, mature companies; the other around income inequality. Neither has much to do with the use of stock options by startups, but startups are adversely impacted by the outcome of these debates all the same.

The corporate governance debate is the oldest. Corporate managers are in the decision-making business: committing investors' resources to corporate projects and then effecting a multitude of adjustments, large and small, over the course of many years to ensure the organization succeeds in these projects. These decisions can be skewed by managers' prejudices, inertia, failures of character, indifference, foolish disregard for risk, too extreme fear of risk, self-interest, and inattention. If a corporation can improve the decision-making of its managers in a broad and systematic way, it will achieve materially better returns from its opportunities. Properly calibrating executive pay structures has generally been seen as the best tool available to do this.

Economics is predicated on the idea that people respond to incentives and so a great deal of the debate about corporate governance has revolved around the proper structure of executive compensation.[6] This has not been considered a simple task and

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[6] Michael C Jensen & William H Meckling, "Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure" (1976) 3:4 J Financial Economics 305 at 309–10 (usually credited with beginning the modern discussion of how manipulating the agent's compensation incentives can maximize the principal's welfare); Michael C Jensen & Kevin J Murphy, "Performance Pay and Top-Management Incentives" (1990) 98:2 J Political Economy 225 at 227–28; Bengt Holmstrom, "Moral Hazard in Teams" (1982) 13:2 Bell J Economics 324 at 325 (noting that the principal in an agency relationship must administer incentive schemes to control free riding); Martin J Conyon, "Executive Compensation and Incentives" (2006) 20:1 Academy Management Perspectives 25 ("[p]rincipal-agent theory predicts that a firm designs contracts in order to yield optimal incentives, therefore motivating the CEO to maximize shareholder value. In designing the contract, the firm recognizes the CEO is risk averse. Thus, imposing greater incentives requires more pay to compensate the agent for increased risk" at 28–29); Sok-Hyon Kang, Praveen Kumar & Hyunkoo Lee, "Agency and Corporate Investment: The Role of Executive Compensation and Corporate Governance"

executive compensation packages have grown increasingly complex over the past several decades.[7] An executive compensation advisory industry has grown alongside the changing compensation norms and very few boards now set executive compensation without input from specialized consultants.[8] For their part, the advice provided to institutional shareholders by proxy advisory firms such as Institutional Shareholder Services and Glass-Lewis on the subject of executive pay is so complex that it won't fit in their proxy voting guidelines, requiring separate detailed treatment.[9] Even these stand-alone executive pay guidelines don't include many of the models required to actually evaluate pay practices and generate voting outcomes.[10]

For reasons we will discuss later, since the dot-com collapse and the Enron era frauds, stock options have been a major issue in arguments amongst managers, boards, proxy advisors, compensation consultants, and the various third parties that concern themselves with corporate governance.[11] Well-coordinated shareholder proposal campaigns have been launched against Canada's largest companies demanding the curtailment of their use of stock options.[12] An article in the (usually

(2006) 79:3 J Bus 1127 at 1128; Jared Harris & Philip Bromiley, "Incentives to Cheat: The Influence of Executive Compensation and Firm Performance on Financial Misrepresentation" (2007) 18:3 Organization Science 350 at 350.

[7] One survey of executives "paint[s] a grim picture for long-term incentives. Many of their key characteristics—high risk, complex and ambiguous performance conditions, arbitrary and unfair outcomes, multi-year deferral—suggest that individuals will discount them to a fraction of their economic value." PwC, "Making Executive Pay Work: The Psychology of Incentives" (2012) at 24, online (pdf): *PwC* <www.pwc.com/gx/en/hr-management-services/publications/assets/making-executive-pay-work.pdf>.

[8] One study found that over 85% of its sample public companies made use of compensation consultants in setting senior executive pay. See Brian Cadman, Mary Ellen Carter & Stephen Hillegeist, "The Incentives of Compensation Consultants and CEO Pay" (2010) 49:3 J Accounting & Economics 263 at 279.

[9] See Institutional Shareholder Services, "2013 Comprehensive US Compensation Policy" (8 March 2013), online: *ISS* <www.issgovernance.com/policy-gateway/2013-comprehensive-us-compensation-policy/>.

[10] Bryce C Tingle, "The Agency Cost Case for Regulating Proxy Advisory Firms" (2016) 49:2 UBC L Rev 725 (discussing the "black box" used by proxy advisors to generate voting outcomes on compensation matters).

[11] See discussion at text accompanying notes 52−100.

[12] See e.g. the shareholder proposal of United Brotherhood of Carpenters and Joiners, Local 27 Pension Trust to EnCana Corporation for their April 28, 2004 Annual General Meeting in Shareholder Association for Research Education (SHARE), "2004 Shareholder Proposals Submitted to Canadian Corporations" (4 August 2004) at 3, online (pdf): *Shareholder Association for Research & Education* <share.ca/files/pdfs/2004%20Shareholder%20Proposals.pdf> (asking for the replacement of options with time and performance based restricted shares); shareholder proposal of Robert Verdun to Canadian Imperial Bank of Commerce for their February 27, 2003 Annual General Meeting asking the bank to phase out options, "2003 Shareholder Proposals Submitted to Canadian Corporations" (16 November 2004) at 1, online (pdf): *Shareholder Association for Research & Education* <share.ca/files/pdfs/2003%20Shareholder%20Proposals%20FINAL.pdf>. See also a series of proposals from MEDAC to eliminate stock options in the 2014 proxy season including proposals made to National Bank of Canada, Bank of Nova Scotia, Bank of Montreal, Laurentian Bank, Royal Bank, and Toronto Dominion Bank where SHARE generally supports these sorts of proposals, in Shareholder Association for Research & Education (SHARE), "Proxy Alert – Upcoming Proxy Vote: Shareholder Proposals Target

staid) Canadian Chartered Accountant's professional publication, can, without much further elaboration, refer to "Shareholder and political controversy over lavish salaries, perks and dubious compensation tools, such as stock options…", suggesting that their continuing use is a function of managerial intransigence.[13] Similar sentiments can be found in Canada's national newspapers,[14] the reports issued by think-tanks,[15] and statements by the tribunes of good governance in Canada such as the Shareholder Association for Research and Education (SHARE) and Canadian Coalition for Good Governance.[16] In every case the arguments against stock options are couched in terms that suggest the continuing use of options represents a failure of governance.[17]

The second argument about stock options has revolved around the growth of income inequality in the West over the past forty years or so. The most prominent advocate of the view that stock options are central to this story is Thomas Piketty, who pointed out in *Capital in the Twenty-First Century*, that stock options are "a form of

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Stock Options as a Form of Executive Pay" (2014), online (pdf): *Shareholder Association for Research & Education* <share.ca/files/Proxy_Alert_1_2014-Bank_stock_options.pdf>.

[13] John Lorinc, "Occupy Corporate Governance", *CA Magazine* 145:8 (October 2012) 18 at 22. See also Ira M Millstein, "Corporate Governance: A North American Perspective" (2006), Global Corporate Governance Forum: Private Sector Opinion Issue 3, at 8, online (pdf): *The World Bank* <documents1.worldbank.org/curated/en/675311468142477561/pdf/382240Corporat1ue130Nov00601PU BLIC1.pdf> (attributing large Canadian pay increases to option grants and suggesting that boards are management dominated and are not stepping up fast enough).

[14] See e.g. Edward Trapunski, "C-suite Addiction to Stock Options no Bonus for Shareholders", *The Globe and Mail* (6 May 2013), online: <www.theglobeandmail.com/globe-investor/investor-community/trading-shots/c-suite-addiction-to-stock-options-no-bonus-for-shareholders/article11730848/> ("While stock options are a no-lose proposition for those who get them, they are a no-win situation for existing shareholders.") See also David Milstead, "Bank Investors, Watch for the Vote on CEO Pay", *The Globe and Mail* (21 February 2014), online: <www.theglobeandmail.com/globe-investor/investment-ideas/banks-investors-watch-for-the-vote-on-ceo-pay/article17040695/>.

[15] Yvan Allaire, "Pay for Value: Cutting the Gordian knot of Executive Compensation" (2012) at 8–12, online (pdf): *Institute for Governance of Private and Public Organizations* <igopp.org/wp content/uploads/2014/04/pp_payforvalue_allaire_en_v4.pdf>.

[16] See e.g. SHARE's 2012 and 2013 summaries of Proxy Vote Survey Reports. Catherine Smith, "2012 Key Proxy Vote Survey" (2013) at 15–20, online (pdf): *Shareholder Association for Research & Education* <www.share.ca/files/2012_Proxy_Vote_Survey_English_FINAL_1.pdf>; Catherine Smith, "2013 Key Proxy Vote Survey" (2014) at 17–20, online (pdf): *Shareholder Association for Research & Education* <share.ca/documents/proxy_voting_reports/Proxy_Vote_Survey/2013/Proxy_Vote_Survey_EN.pdf>; Canadian Coalition for Good Governance, "2015 Best Practices for Proxy Circular Disclosure" (2015), online (pdf): *CCGG* <ccgg.ca/wp-content/uploads/2019/01/2015_best_practices-ccgg-1-1.pdf> ("Stock options, which provide upside leverage to the share price with no downside exposure, are not appropriate for directors of public companies" at 18).

[17] See e.g. a shareholder proposal for the Bank of Montreal ("Phasing out stock options as a form of compensation" (2014), online: *Shareholder Association for Research & Education* <share.ca/share-proposals/phasing-out-stock-options-as-a-form-of-compensation/>):

> The executive compensation must be based on solid performance criteria that executives can control and promote the creation of long-term added value for the organization. However, the main objective of stock options as a form of compensation is to reward and motivate executives by linking the executives' performance to the organization's share performance. However, such a linkage is far from being established.

remuneration that has played an important role in the increase of wage inequality…”.[18] Other observers have noted that “The staggering increases in the compensation of corporate executives of US Stock-exchange listed companies stems particularly from stock options and other forms of compensation that are linked to the value of the corporate stock.”[19]

The politicians have noticed. The 2015 national election included pledges by the Liberals and NDP to increase the taxation of stock options.[20] There was an aborted attempt by the Liberals to do so in 2016, that was withdrawn because of protests from Canada’s startup community.[21] However, in June 2019, the government introduced a Notice of Ways and Means Motion to effect changes to the taxation of stock options with the express goal of reducing inequality.[22] The Department of Finance’s press release noted the benefits of the tax treatment of options, “are disproportionately going to a very small number of high-income individuals.”[23] The release goes on to note that six per cent of stock option deduction claimants accounted for almost two-thirds of the cost of the deduction to taxpayers.[24]

The most recent federal government proposal is well defined, except around the treatment of startups. This is surprising, because, as the 2019 federal budget notes, “The public policy rationale for preferential tax treatment of employee stock options is to support younger and growing Canadian businesses.”[25]Canadian-Controlled Private Corporations (CCPCs), the conceptual workhorse of tax policy when it comes

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[18] Thomas Piketty, *Capital in the Twenty-First Century*, translated by Arthur Goldhammer (Cambridge, MA: Harvard University Press, 2014) at 381.

[19] Yvan Allaire & Mihaela Firsirotu with the collaboration of François Dauphin, “Inequality and Executive Compensation: Why Thomas Piketty is Wrong?” (2014) at 20, online (pdf): *Institute for Governance of Private and Public Organizations* <igopp.org/wp-content/uploads/2014/06/Allaire_et_Firsirotu-Economic-Inequality-Why-Piketty-is-wrong-June-25-2014-YA-30-juin.pdf>.

[20] Garry Marr, “Liberal and NDP’s Plans to Boost Tax on Stock Options Could Cost Taxpayers Money, Study Finds”, *Financial Post* (7 October 2015), online: <financialpost.com/executive/c-suite/liberal-and-ndps-plans-to-tax-stock-options-could-cost-taxpayers-money-study-finds>.

[21] Sean Silcoff, “Liberals Drop Controversial Stock Options Tax Plan”, *The Globe and Mail* (22 March 2016), online: <www.theglobeandmail.com/report-on-business/small-business/startups/liberals-drop-controversial-stock-options-tax-plan/article29337792/>.

[22] Department of Finance Canada, News Release, “Government of Canada to Make Tax System Fairer, Launches Consultations on Stock Options” (17 June 2019), online: <www.canada.ca/en/department-finance/news/2019/06/government-of-canada-to-make-tax-system-fairer-launches-consultations-on-stock-options.html>.

[23] *Ibid*.

[24] *Ibid*. Some have pointed out that 2017 was a particularly busy year in terms of M&A activity and these statistics may not be “consistent with long-term market trends”, see Ehsan Wahidie, “Budget 2019: Government Seesawing on Taxation of Stock Options” (March 2019), online (pdf): *Mcmillan* <mcmillan.ca/Files/213607_Budget_2019_-_Stock_option_measures.pdf>.

[25] Government of Canada, *Budget 2019 Chapter 4: Delivering Real Change, Part 7: A Fair Tax System for All Canadians* (Ottawa: Government of Canada, March 2019), online: <budget.gc.ca/2019/docs/plan/chap-04-en.html#Employee-Stock-Options>.

to entrepreneurs, would be excluded from the changes, but the government is not sure what to do about "non-CCPCs [that] could be startups, emerging or scale-up companies."[26] The government is looking for input about how to distinguish this type of company.

II. The Use of Stock Options by Canadian Startups

Startups or "growth companies" (the terms will be used interchangeably) are relatively young companies with the intention—often not realized—of growing rapidly in terms of employees and revenue. The idealized startup is one that is developing and commercializing a new technology, but in fact Canadian growth companies arise in any industry. However, they all tend to pursue a potentially valuable innovation in the way firms in that industry have previously operated. This strategic dependence on new and untested products, services, or methods, along with their small size, need for outside capital, and often unexperienced management teams, makes them unusually risky.[27]

Importantly, though, these smaller, high-risk businesses create nearly half of Canada's net new jobs and a significant percentage of its economic growth.[28] For example, high growth firms in Canada accounted for only 4 per cent of Canadian businesses but 45 per cent of the net jobs created during a typical decade.[29] Using venture capital-backed companies as a proxy for growth companies generally, research has found they achieve sales growth five times greater than the Canadian private sector as a whole, nine times faster employment growth, and export 70 per cent of their sales—four times the Canadian average.[30] Canadian growth companies are also disproportionately innovative, conducting more R&D and filing more patents per dollar invested than more established firms.[31]

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[26] Department of Finance Canada, *supra* note 22.

[27] Only about eight percent of startups in Canada actually achieve a high rate of growth: *The State of Entrepreneurship in Canada*, by Eileen Fisher & Rebecca Reuber (Ottawa: Government of Canada Publications, February 2010) at 9–10, online (pdf): *Industry Canada* <www.ic.gc.ca/eic/site/061.nsf/vwapj/sec-eec_eng.pdf/$file/sec-eec_eng.pdf>.

[28] See *Profile of Growth Firms: A Summary of Industry Canada Research,* by Chris Parsley & David Halabisky (Ottawa: Industry Canada, March 2008) at 4, online (pdf): *Industry Canada* <www.ic.gc.ca/eic/site/061.nsf/vwapj/ProfileGrowthFirms_Eng.pdf/$file/ProfileGrowthFirms_Eng.pdf>. See also Bryce Tingle, *Start-up and Growth Companies in Canada: A Guide to Legal and Business Practice* (Markham, Ontario: LexisNexis Canada, 2005) at 18–19 [Tingle, *Start-up and Growth Companies in Canada*].

[29] Industry Canada, Chris Parsley & David Halabisky, *supra* note 28 at 1, 4.

[30] Gilles Duruflé, "Why Venture Capital is Essential to the Canadian Economy" (January 2009) at 24, 26, online (pdf): *Canada's Venture Capital and Private Equity Association* <en.ebdata.com/wp-content/uploads/2012/04/CVCA_VC_Impact_Study_Jan_2009_Final_English.pdf>.

[31] John R Baldwin, "A Portrait of Entrants and Exits" (Paper prepared for a conference on small firms, organized by the Small Business Administration, Washington, DC, June 1997) at 33, online (pdf): *Statistics Canada* <www150.statcan.gc.ca/n1/en/pub/11f0019m/11f0019m1999121-eng.pdf?st=fjCnsNAl> (Finding

It is worth noting as well, that Canadian growth companies compare favourably with their peers in the United States. Again, taking venture-backed companies as an example, (they are a small subset of growth companies, but one for which statistics are tracked) Canadian growth companies have higher exit values per dollar invested and per dollar of R&D spent, than comparable American companies.[32]

Fostering growth companies is generally regarded by policymakers as essential to preserve an economy's competitiveness and productivity.[33] This is why, for example, the Canadian government has created various tax programmes, including some relating to the taxation of stock options, designed to foster the flourishing of startups in this country.[34]

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that faster growing early-stage companies innovate at almost twice the rate of slower growing peers); Josh Lerner, "Boom and Bust in the Venture Capital Industry and the Impact on Innovation" (2002) 87:4 Federal Reserve Bank Atlanta Economic Rev Fourth Quarter 25 (Finding that "on average a dollar of venture capital [given exclusively to growth companies] appears to be three to four times more potent in stimulating patenting than a dollar of traditional corporate R&D" at 35); Gilles Duruflé, *supra* note 30 at 25 (Canadian venture backed companies devote 54% of their employees to R&D and hold an average of 10 patents); Industry Canada, *SME Financial Data Initiative: High Growth SMEs,* by Patrick Huot & Christine Carrington (Ottawa: Industry Canada, May 2006) at 6, online (pdf): *Industry Canada* <ic.gc.ca/eic/site/061.nsf/vwapj/highgrowthprofile_eng.pdf/$file/highgrowthprofile_eng.pdf> (Finding that high growth SMEs are significantly more likely to invest in R&D than Canadian businesses generally).

[32] Thomas F Hellmann, Edward J Egan & James A Brander, "Value Creation in Venture Capital: A Comparison of Exit Values Across Canadian Provinces and US States" (October 2005), online (pdf): <www.angelblog.net/documents/value_creation_vc_study_oct2005.pdf>.

[33] John Haltiwanger et al, "High Growth Young Firms: Contribution to Job, Output and Productivity Growth" (2017) Center for Economic Studies (CARRA) Working Paper No 2017-03. See also Innovation, Science and Economic Development Canada, *Building a Nation of Innovators* (Ottawa: Innovation, Science and Economic Development Canada, 2019), online (pdf): *Government of Canada* <www.ic.gc.ca/eic/site/062.nsf/vwapj/ISEDC_19-044_INNOVATION-SKILLS_E_web.pdf/$file/ISEDC_19-044_INNOVATION-SKILLS_E_web.pdf>; Canada's Economic Strategy Tables, *The Innovation and Competitiveness Imperative: Seizing Opportunities for Growth* (Ottawa: Innovation, Science and Economic Development Canada, 25 September 2018), online (pdf): *Government of Canada* <www.ic.gc.ca/eic/site/098.nsf/vwapj/ISEDC_SeizingOpportunites.pdf/$file/ISEDC_SeizingOpportunites.pdf>.

[34] See other tax initiatives frequently defended on the basis of their role in fostering growth companies: Government of Canada, "Scientific Research and Experimental Development Tax Incentive: Overview" (last modified 31 March 2020), online: *Government of Canada* <www.canada.ca/en/revenue-agency/services/scientific-research-experimental-development-tax-incentive-program/overview.html>; National Research Council Canada, "NRC IRAP Innovation Assistance Program (IAP)" (last modified 22 April 2020), online: *Government of Canada* <nrc.canada.ca/en/support-technology-innovation/nrc-irap-innovation-assistance-program-iap>; Government of Canada, "Lines 41300 and 41400 – Labour-sponsored funds tax credit" (last modified 03 March 2020), online: *Government of Canada* <www.canada.ca/en/revenue-agency/services/tax/individuals/topics/about-your-tax-return/tax-return/completing-a-tax-return/deductions-credits-expenses/lines-413-414-labour-sponsored-funds-tax-credit.html>; Government of Canada, "Capital Gains Deferral for Investment in Small Business" (last modified 21 January 2020), online: *Government of Canada* <www.canada.ca/en/revenue-agency/services/tax/individuals/topics/about-your-tax-return/tax-return/completing-a-tax-return/personal-income/line-127-capital-gains/capital-losses-deductions/capital-gains-deferral-investment-small-business.html>. See generally John Lester, "Policy Interventions Favouring Small Business: Rationales, Results and Recommendations" (2017) 10:11 U Calgary School Public Policy Publications 1 at 2–4.

Startups have a very different relationship to equity incentives than larger, more mature companies. Indeed, income inequality and the proper calibration of incentives (the preoccupations of corporate governance elites and the Federal government) are issues that are largely irrelevant to growth companies.

The key concern for these riskier companies with less free cash flow to use for compensation, is the impact of various executive compensation structures in recruiting and retaining managers. This is particularly important for two reasons. First, a well-known feature of rapid corporate growth is that it is accompanied by nearly continual change in senior leadership as founders reach the limits of their competency or burn out, and as new stages of development require new levels and types of managerial experience.[35] Second, most growth companies can match neither the salaries nor the security of more established competitors for executive talent. This makes their only advantage—the growth prospects of their equity—a particularly important part of its compensation arrangements.

Equity is regarded as cheap to the company and attractive to high quality employees. Saying that equity is "cheap" does not mean that equity incentives don't have a "cost". They obviously result in shareholder dilution and thus the reduction of corporate cash flows to the pre-existing shareholders. Since 2001, Canadian companies have been required to disclose the cost of outstanding conditional equity grants, such as stock options, in their financial statements.[36] But equity awards like stock options don't take up any of the company's internal cash and for certain kinds of companies, those with the biggest opportunities, internal cash is extremely valuable. Indeed, studies in the United States find that employment and sales growth are *negatively* correlated with profitability, underlying the importance of equity being available to recruit talent.[37]

For highly talented executives of the sort startups desperately need to attract, the chance to own equity is almost the only available inducement to accept an employment offer. On virtually every other measure, employment in a startup is worse than a job in a more established company. A growth company's business model is untried and changes rapidly, salaries are always lower than they would be elsewhere,

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[35] Michael Ewens & Matt Marx, "Founder Replacement and Startup Performance" (2018) 31:4 Rev Financial Studies 1532 at 1541 (twenty percent of VC-backed firms experienced a founder replacement event); Warren Boeker & Rushi Karichalil, "Entrepreneurial Transitions: Factors Influencing Founder Departure" (2002) 45:4 Academy Management J 818; Michael Gorman & William A Sahlman, "What Do Venture Capitalists Do?" (1989) 4 :4 J Bus Venturing 231 at 241 (finding that the statistical mean is one termination of a CEO/President for every 2.4 years of a venture capitalist's investing experience).

[36] See Ed Abahoonie & Koen De Grave, "Stock Option Awards Under IFRS: An Analysis of the Potential Impact" (2008), online (pdf): *PricewaterhouseCoopers* <www.pwc.com/en_US/US/tax-accounting-services/assets/stock_options_under_IFRS.pdf>; "ASPE – IFRS: A Comparison: Share Based Payments" (15 February 2017), online (pdf): *BDO* <bdo.ca/BDO/media/Professional-Profile-Images/ASPE_IFRS-Comparison_Share-Based-Payments_FINAL_1.PDF>.

[37] Gideon D Markman & William B Gartner, "Is Extraordinary Growth Profitable? A Study of *Inc. 500* High-Growth Companies" (2002) 27:1 Entrepreneurship Theory & Practice 65.

the firm could run out of money at any point, there are frequent management changes, power in the firm is volatile and prone to sudden change, competitors are larger with greater resources, and the startup has a very good chance of failing, which brings reputational risks to its senior management.[38] A big reason most senior employees join a growth company is because the equity incentives on offer will make them very wealthy if the company is a success.[39]

Research in Canada on the differences between faster and slower growing new firms has established that the human resource strategy with the greatest impact on growth is the provision of incentive compensation plans.[40] Equity incentives are better predictors of fast growth than training programs or even the recruitment of skilled employees.[41] Post-IPO, the more exposure a company's executives have to various equity incentives, the faster sales, earnings, return on assets and share price grow.[42]

Start-ups and fast growing companies thus make heavy use of equity in their compensation arrangements.[43] In 73% of American venture capital-backed companies every single employee holds stock options.[44] At the time successful American companies conduct their Initial Public Offering, employees own approximately 20% of the shares and the founders (who are often still executives of the company) own a further 10-20%.[45] Thus, in the most successful growth companies (the ones that make it to IPO) insiders hold an extremely large percentage of the company, the majority of which is held by individuals joining the business after its initial formation.

Equity incentives, whether in the form of stock options or outright grants of shares, are absolutely necessary to startups. Without them, firms cannot attract the

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[38] Tingle, *Start-up and Growth Companies in Canada*, *supra* note 28 at 8–17.

[39] John RM Hand, "Give Everyone a Prize? Employee Stock Options in Venture-backed Firms" (2008) 23:4 J Bus Venturing 385.

[40] John Baldwin, "Innovation and Training in New Firms" (Paper presented to a conference devoted to "Assessing the Impact of Training on the Permanence of Small and Medium Sized Enterprises" held jointly by the Centre for Business Research, University of Cambridge and the Centre for Small and Medium Sized Enterprises, University of Warwick, March 1998) at 25–26, online (pdf): *Statistics Canada* <www150.statcan.gc.ca/n1/en/pub/11f0019m/11f0019m2000123-eng.pdf?st=pJt5I-vu>.

[41] Ibid.

[42] Kuntara Pukthuanthong, Richard Roll & Thomas Walker, "How Employee Stock Options and Executive Equity Ownership Affect Long-Term IPO Operating Performance" (2007) 13:5 J Corporate Finance 695 at 716.

[43] Kiridaran Kanagaretnam, Gerald J Lobo & Emad Mohammad, "Are Stock Option Grants to CEOs of Stagnant Firms Fair and Justified?" (2009) 90:1 J Bus Ethics 137 at 141–42 (finding that option grants are the largest component of compensation for growth firms in contrast with stagnant firms, in which salary compensation predominates).

[44] Hand, *supra* note 39 at 388–89.

[45] See Steven N Kaplan, Berk A Sensoy & Per Strömberg, "What Are Firms? Evolution from Birth to Public Companies" (2005) National Bureau of Economic Research Working Paper No 11581 at Table 11, online (pdf): *National Bureau of Economic Research* <www.nber.org/papers/w11581>; Tingle, *Start-up and Growth Companies in Canada, supra* note 28 at 151.

talent they require, particularly experienced managerial, financial, sales, and marketing executives. For this task, Canadian growth companies use stock options almost exclusively.[46] As an example, the TSX Venture 50 is a ranking of the strongest performers across five industry sectors (ten chosen from each).[47] On average the TSX Venture 50 companies delivered an annualized return of 173% over a representative year. Some of them grew five-fold in that time. They serve as good proxy, then, for the kind of company we are most concerned to foster in this country and the kind of company that most depends on equity incentives to attract and retain executives.[48] Hand-collected data from the TSX Venture 50 companies' 2013 proxy season information circulars shows that in the previous three years (for an aggregate of 150 years of executive compensation decisions) every one of the companies had issued stock options, whilst only four had ever used a share grant.[49] For only two companies did share grants exceed in value the options granted during those three years. Stock options accounted for approximately 88% of the value of equity issued by these companies over the three-year time period.[50]

While only anecdotal evidence is available about the practices of private Canadian growth companies, it seems to suggest they also use stock options almost exclusively.[51]

III. The Problems with Stock Options

The use of stock options in Canada and elsewhere exploded in the 1990s, but the seeds had been planted in the previous decade by academics that promoted the value of

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[46] Antonio Spizzirri, "Canadian Director Compensation Analysis 2009-2012" (March 2014), online (pdf): *Rotman School of Management* <www.rotman.utoronto.ca/-/media/Files/Programs-and-Areas/CCBE/Canadian%20Director%20Compensation%20Analysis%2009-12%20March%202014%20Web.pdf> ("[t]ypically, smaller issuers grant more options to their directors than their larger counterparts" at 3).

[47] See "Venture 50 2020", online: *TMX Money* <tmxmoney.com/en/investor_tools/tsxventure50.html>.

[48] See discussion at text accompanying notes 16 and 43–45 above.

[49] This data is in the author's possession.

[50] *Ibid.* $4,827,909 in reported value of share grants vs. $39,624,885 in reported value in option grants. Note this is Black-Scholes valuations of the options. Measured solely in terms of, say, exposure to share price growth the statistics would even more lopsidedly favour stock options.

[51] Tingle, *Start-up and Growth Companies in Canada*, *supra* note 28 at 157; Serena Lefort, "Reward Key Employees with Stock Options", *Financial Post* (19 March 2012), online: <financialpost.com/entrepreneur/reward-key-employees-with-stock-options> ("I'm seeing more private companies interested in setting up stock option plans"); "Executive Compensation Guide for Canadian Officers and Directors" (2014), online (pdf): *Stikeman Elliot LLP* <stikeman.com/en-ca/kh/guides/Executive-Compensation-in-Canada> ("other [non-option] types of stock-based compensation plans that are more common in the U.S. (such as restricted stock plans) may not provide similar tax benefits and may even result, in many circumstances, in undesirable tax consequences for Canadian executives … The result is that compensation plans of those types are not as prevalent in Canada as they are in the United States" at 11).

equity components in executive pay as a method of ameliorating agency costs.[52] In this early work, employee stock options were explicitly identified as leading to stronger alignment of management and shareholder goals.[53] By the 1990s, large institutional shareholders such as CalPERS (the largest public pension fund in the US) and governance bodies like the National Association of Corporate Directors were calling for "a significant amount of director compensation to be paid in the form of stock grants and options"[54] By the end of the decade, a Harvard Business Review article could opine: "Options are the best compensation mechanism we have for getting managers to act in ways that ensure the long-term success of their companies and the well-being of their workers and stockholders."[55]

Boards responded to these changes to governance norms and began issuing options in large numbers as the decade progressed. In the United States, option compensation comprised 20% of CEO pay in 1992, but rose to a "staggering" 49% in 2000.[56] By the beginning of this century, S&P 500 index companies were granting six times more options than they had a decade previously.[57] The unprecedented growth in CEO pay over the decade was almost entirely a reflection of this increase in the use of stock options.[58]

Canadian companies followed suit. In 1991, only 33% of the largest 100 Canadian public companies granted stock options to their executives; by 2000, 100% of them did.[59] Smaller Canadian companies replicated this increasing use of options.[60] While it never reached the size it did in the United States, by 2002, 36% of the

[52] See e.g. Holmstrom, *supra* note 6; Eugene F Fama, "Agency Problems and the Theory of the Firm" (1980) 88:2 J Political Economy 288. See also Jensen & Murphy, *supra* note 6.

[53] Jensen & Murphy, *supra* note 6 at 226; Kevin J Murphy, "Executive Compensation: Where We are, and How We Got There" in George Constantinides, Milton Harris & Rene Stulz, eds, *Handbook of the Economics of Finance*, vol 2A (Amsterdam: North Holland, 2013) 211; Rachel Merhebi et al, "Australian Chief Executive Officer Remuneration: Pay and Performance" (2006) 46:3 Accounting & Finance 481 at 482; Brian J Hall & Jeffrey B Liebman, "Are CEOs Really Paid Like Bureaucrats?" (1998) 113:3 QJ Economics 653 at 655.

[54] Shamsud D Chowdhury, "Director Compensation: The Growing Popularity of Deferred Stock Units" (2009) 73:1 Ivey Bus J 11 at 11.

[55] Brian J Hall, "What You Need to Know about Stock Options" (2000) 78:2 Harvard Bus Rev 121 at 122.

[56] Carola Frydman & Dirk Jenter, "CEO Compensation" (2010) National Bureau of Economic Research Working Paper No 16585 at 6.

[57] Brian J Hall & Kevin J Murphy, "The Trouble With Stock Options" (2003) 17:3 J Economic Perspectives 49 at 49 [Hall & Murphy, "Trouble With Stock Options"].

[58] Kevin J Murphy, "Explaining Executive Compensation: Managerial Power Versus the Perceived Cost of Stock Options" (2002) 69:3 U Chicago L Rev 847 at 847–48.

[59] Ryan Compton, Daniel Sandler & Lindsay Tedds, "Options Backdating: A Canadian Perspective" (2009) 47:3 Can Bus LJ 363 at 363.

[60] For example, Zhou found that "Among the TSE300 firms, 90 per cent had an annual bonus plan and used stock options in compensating their executives." Xianming Zhou, "CEO Pay, Firm Size, and Corporate Performance: Evidence From Canada" (2000) 33:1 Can J Economics 213 at 217.

compensation received by TSX 60 CEOs was received from stock options.[61] This was the largest single component—by far—of Canadian executive pay packages.[62]

It was about this time that options began to fall out of favour with academics and governance activists. The decline is sometimes linked to accounting changes early in the last decade that required companies to begin expensing options.[63] A study in Canada, however, found that while option use decreased around the time of the accounting changes, it did not decrease in the ways we would expect if prior option use had been primarily a function of its invisibility in corporate cash flow statements.[64] Instead, the decline is likely due to the growing appreciation that stock options are a sub-optimal way to motivate executives.

First, in the early years of this century, finance academics began pointing out that the structure of options encourages excessive risk-taking.[65] Options pay out if the stock price exceeds the exercise price and, obviously, the greater the increase in the share price, the larger the payout. But there is no penalty to the option holder if the share price declines below the exercise price. The options become worthless, but the executive doesn't lose any money. Indeed, it makes no difference to the executive option-holder whether the share price declines slightly below the exercise price or dives well below the exercise price. The options are equally worthless in either scenario. This means that the rational thing for an executive holding options to do is swing for the fences—take the big risks. If this strategy pays off, the executive makes a lot on the options; if it fails, she isn't harmed. From her perspective there is no

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[61] Allaire, *supra* note 15 at 22.

[62] *Ibid.* In contrast, salary amounted to 27% and bonuses to 25%.

[63] See e.g. Frydman & Jenter, *supra* note 56 ("[m]oreover, it is likely that both the prior decline in the stock market and the advent of option expensing in 2004 have contributed to the declining popularity of stock options in recent years" at 6). See also Iman Anabtawi, "Explaining Pay Without Performance: The Tournament Alternative" (2005) 54:4 Emory LJ 1557 at 1576.

[64] See Karrie Geremia, Carla Carnaghan & Toni Nelson, "Exploring Changes in Management Compensation Structure in Canada: Evidence on the Consequences of Requiring Options Expensing" (Canadian Academic Accounting Association Annual Conference 2010 delivered at the Hyatt Regency Vancouver, 29 May 2010), online: *SSRN* <papers.ssrn.com/sol3/papers.cfm?abstract_id=1534381> ("[t]hese findings suggest that firms that would have been expected to engage in earnings management or managerial opportunism did not significantly decrease ESO [employee stock option] use when favorable accounting treatment that would enable such behaviors ended" at 35). See also Richard Ericson, "Value Rules: Senior Management Incentives in the Post-Option Era" (2004) 20:1 Benefits Q 23 (analyzing the stock performance of companies that announced in 2002 that they would expense options: "Accounting doesn't matter. Businesses are valued based upon economic results, not upon their accounting portrayal" at 27).

[65] Lucian Bebchuk & Jesse Fried, "Executive Compensation as an Agency Problem" (2003) 17:3 J Economic Perspectives 71 at 83–85; Hall & Murphy, "Trouble With Stock Options," *supra* note 57 at 49.

reason to minimize losses.[66] Both the 2001 and 2008 financial crises were blamed on this aspect of stock options.[67]

In the febrile atmosphere following the discovery of the Enron-era accounting frauds,[68] options were also accused of promoting unethical behaviour.[69] All equity incentives arguably encourage manipulation of share prices, but because options typically have short vesting periods (three or four years), must be exercised before they expire (usually five to ten years after issue), and can be exercised opportunistically at the discretion of the executive, options will inevitably occasionally function as a short-term incentive.[70] And in the short-term, share prices can be manipulated, through accounting fraud,[71] earnings management,[72] misleading public

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[66] Harley E Ryan Jr & Roy A Wiggins III, "The Interactions Between R&D Investment Decisions and Investment Policy" (2002) 31:1 Financial Management 5 at 27 (noting that option awards to managers encourages them to invest with more risk).

[67] Sanjai Bhagat & Brian Bolton, "Financial Crisis and Bank Executive Incentive Compensation" (2014) 25 J Corporate Finance 313 at 313; Hamid Mehran, Alan Morrison & Joel Shapiro, "Corporate Governance and Banks: What Have We Learned from the Financial Crisis?" (2011) Federal Reserve Bank of New York Staff Report No 502 at 7–8, online (pdf): *New York Federal Reserve* <www.newyorkfed.org/research/staff_reports/sr502.pdf>; Kevin J Murphy, "Pay, Politics, and the Financial Crisis" in Alan S Blinder, Andrew W Lo & Robert M Solow, eds, *Rethinking the Financial Crisis* (New York: Russell Sage Foundation, 2012) 303 [Murphy, "Pay, Politics, and the Financial Crisis"].

[68] For a list of some Enron-era accounting scandals, see Interview of Jonathan Karpoff, "The Decade's Worst Financial Scandals" (5 April 2010), online: *University of Washington Foster School of Business* <foster.uw.edu/research-brief/the-decades-worst-financial-scandals/>.

[69] Roger Martin, *Fixing the Game: Bubbles, Crashes, and What Capitalism Can Learn from the NFL* (Boston: Harvard Business Review Press, 2011) at 27–30, 95–99 (detailing the kinds of unethical behaviour created by strong share-price linked incentives).

[70] Brian J Hall & Kevin J Murphy, "Stock Options for Undiversified Executives" (2002) 33:1 J Accounting & Economics 3 at 4 [Hall & Murphy, "Stock Options for Undiversified Executives"]; Kevin J Murphy, "Stock-Based Pay in New Economy Firms" (2003) 34:1/3 J Accounting & Economics 129 at 142–43.

[71] Shane A Johnson, Harley E Ryan Jr & Yisong S Tian, "Managerial Incentives and Corporate Fraud: The Sources of Incentives Matter" (2009) 13:1 Rev Finance 115 at 116–17; Lin Peng & Ailsa Roell, "Executive Pay and Shareholder Litigation" (2008) 12:1 Rev Finance 141 at 142; David Denis, Paul Hanouna & Atulya Sarin, "Is there a dark side to incentive compensation?" (2006) 12:3 J Corporate Finance 467 at 468; Joseph P O'Connor Jr et al, "Do CEO Stock Options Prevent or Promote Fraudulent Financial Reporting?" (2006) 49:3 Academy Management J 483 at 492–93; Harris & Bromiley, *supra* note 6 at 361.

[72] See e.g. Natasha Burns & Simi Kedia, "The Impact of Performance-based Compensation on Misreporting" (2006) 79:1 J Financial Economics 35 at 37; Qiang Cheng & Terry D Warfield, "Equity Incentives and Earnings Management" (2005) 80:2 Accounting Rev 441 at 443; Daniel Bergstresser & Thomas Philippon, "CEO Incentives and Earnings Management" (2006) 80:3 J Financial Economics 511 at 514; Jap Efendi, Anup Srivastava & Edward P Swanson, "Why Do Corporate Managers Misstate Financial Statements? The Role of Option Compensation and Other Factors" (2007) 85:3 J Financial Economics 667 at 670; Julia Grant, Garen Markarian & Antonio Parbonetti, "CEO Risk-Related Incentives and Income Smoothing" (2009) 26:4 Contemporary Accounting Research 1029 at 1030.

business disclosure,[73] or the pursuit of appealing short-term business strategies that harm the long-term interests of the company.[74]

Other problems with options were identified over time.[75] Once the bull market of the 1990s was over, it became noticeable that options lose their power to either motivate or retain managers when share prices decline below option exercise prices.[76] It also became clear that managers holding stock options tend to reduce dividend payments (in which option holders do not participate) in favour of repurchasing stock (which benefits option holders by increasing share value).[77] As a method of distributing cash not immediately needed by the business, dividends are superior to stock repurchases because the latter encourages a variety of practices that treat shareholders unequally[78] and can run contrary to the long-term interests of the company.[79] These problematic practices arise from the fact that unlike dividends, share repurchases do not treat shareholders equally (the issuer transacts with some shareholders and not with others) which gives rise to the possibility issuers will take

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[73] David Aboody & Ron Kasznik, "CEO Stock Option Awards and the Timing of Corporate Voluntary Disclosures" (2000) 29:1 J Accounting & Economics 73 at 75.

[74] See Bryce Tingle, "Bad Company! The Assumptions Behind Proxy Advisors' Voting Recommendations" (2014) 37:2 Dal LJ 709 at 736–38 [Tingle, "Proxy Advisors' Voting Recommendations"]; See also John R Graham, Campbell R Harvey & Shiva Rajgopal, "The Economic Implications of Corporate Financial Reporting" (2005) 40:1/3 J Accounting & Economics 3 at 4 (finding that managers would rather risk negative long-term consequences through economic actions than make a GAAP accounting decision to manage earnings and that the majority of managers have admitted to forfeiting long-term value in order to smooth earnings).

[75] For a summary of all the concerns raised over the past decade or so about options, see Richard T Holden, "The Original Management Incentive Schemes" (2005) 19:4 J Economic Perspectives 135 at 142–43.

[76] Susan J Stabile, "Motivating Executives: Does Performance-Based Compensation Positively Affect Managerial Performance?" (1999) 2:2 U Pa J Lab & Employment L 227 at 267–68; Viral V Archarya, Kose John & Rangarajan K Sundaram, "On the Optimality of Resetting Executive Stock Options" (2000) 57:1 J Financial Economics 65 at 66–67; Lisa K Meulbroek & Li Jin, "Do Underwater Executive Stock Options Still Align Incentives?: The Effect of Stock Price Movements on Managerial-Incentive Alignment" (2001) Harvard Business School Finance School Working Paper No 02-002 at 9–10, online: *SSRN* <papers.ssrn.com/sol3/papers.cfm?abstract_id=291571>.

[77] Christine Jolls, "Stock Repurchases and Incentive Compensation" (1998) National Bureau of Economic Research Working Paper No 6467 at 1–2, online: *NBER* <www.nber.org/papers/w6467>; Scott J Weisbenner, "Corporate Share Repurchases in the 1990s: What Role do Stock Options Play?" Board of Governors of the Federal Reserve System, Finance and Economics Discussion Series Paper 2000-29 at 2, online (pdf): *United States Federal Reserve* <www.federalreserve.gov/pubs/feds/2000/200029/200029pap.pdf>; Nalinaksha Bhattacharyya, "Good Managers Invest More and Pay Less Dividends: A Model of Dividend Policy" in Mark Hirschey, Kose John & Anil K Makhija, eds, *Issues in Corporate Governance and Finance (Advances in Financial Economics)*, vol 12 (Bingley: Emerald Group, 2007) (noting that dividends are used to remove excess cash from managers and give it to shareholders).

[78] Jesse M Fried, "The Uneasy Case for Favoring Long-Term Shareholders" (2015) 124:5 Yale LJ 1554 at 1593–1618.

[79] Ibid.

advantage of unsophisticated shareholders by buying their temporarily undervalued shares and engage in price-manipulation around repurchases.[80]

The obvious alternative to stock options is to issue shares directly to executives in the form of restricted share grants. (These are shares granted to an executive under an escrow agreement that contains certain conditions for their release. The conditions may be as simple as the passing of one or more vesting periods.) Issuing actual shares is considered to be the gold standard of equity incentives since it places managers in exactly the same position as other shareholders.[81] Unreasonably high-risk business decisions are discouraged since the executive can lose money through a decline in the value of their shares, as well as make money if the bet pays off. Unlike options, shares do not need to be sold by a certain deadline and thus can function as a long-term incentive in a way options are incapable. Because they don't "expire", share grants thus tend to ameliorate the pressures towards unethical or short-term actions intended to manipulate the share price. Shares also remove the bias against dividends and don't lose their power as an incentive if the share price declines below the exercise price. In the words of professors Hall and Murphy, writing at the beginning of the period share grants began to grow in prominence, "when existing compensation is adjusted, incentives are maximized through restricted stock grants rather than options."[82]

There are other advantages of share grants. Studies show that executives value restricted share grants more highly than options.[83] This means less dilution of the shareholders is required when shares are used as equity incentives rather than options. One set of researchers found that it would take a dollar worth of stock options to equal 45 cents in restricted stock.[84] In fact, moving from stock options to share grants may be one of the few free lunches in this world. The cost of shares to the corporation and its shareholders (relative to options) may be less than the value of the shares to executives. Thus, a principal of consulting firm Towers Watson, which specializes in executive pay, writes the following:

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[80] Tingle, "Proxy Advisors' Voting Recommendations", *supra* note 74 at 736.

[81] Mary Ellen Carter, Luann J Lynch & Irem Tuna, "The Role of Accounting in the Design of CEO Equity Compensation" (2007) 82:2 Accounting Rev 327 at 355 (finding that firms are using more restricted stock in order to provide longer-term incentives).

[82] Hall & Murphy, "Stock Options for Undiversified Executives", *supra* note 70 at 26–27. See also Ingolf Dittmann & Ernst Maug, "Lower Salaries and No Options? On the Optimal Structure of Executive Pay" (2007) 62:1 J Finance 303 (demonstrating compensation costs could be reduced by 20% as part of a compensation scheme that involved issuing shares rather than options).

[83] Hall & Murphy, "Stock Options for Undiversified Executives", *supra* note 70 ("options are, in fact, an unusually expensive and therefore inefficient way to convey compensation to executives" at 16).

[84] Lawrence D Brown & Yen-Jung Lee, "Changes in Option-Based Compensation Around the Issuance of SFAS 123R" (2011) 38:9/10 J Bus Finance & Accounting 1053 at 1086–87. See also Dittmann & Maug, *supra* note 82.

> The economic cost to shareholders of a restricted share often is about equal to that of two options. Participants' risk tolerances, on the other hand, cause them to place a higher relative value on restricted stock. They may be happy to give up three options they would otherwise receive for one share of restricted stock. A restructured grant policy can create a win-win situation, retaining or improving participants' satisfaction while lessening economic [and accounting] cost.[85]

The academic concerns about the over-use of options in the 1990s found voice in the calls of institutional investors and governance activists to eschew them in favour of stock grants. In Canada, the Canada Pension Plan Investment Board indicated its support for stock grants rather than stock options.[86] The Canadian Coalition for Good Governance similarly encouraged share grants while criticizing stock options.[87] Its founder, Stephen Jarislowsky, a leading institutional investor in Canada, was more blunt: "Stock options are very dangerous for shareholders—they should be banned."[88] A report from the Institute for Governance of Private and Public Organizations urged directors to, "reduce or, preferably, eliminate stock options from the compensation program."[89]

In the wake of this opprobrium, the use of options predictably declined sharply even as the percentage of executive pay attributable to equity incentives remained constant, or even increased.[90] In the UK stock options were "largely replaced" by performance-contingent stock grants.[91] The largest stock option issuer in history, Microsoft, made a stir in 2004 when it announced it would discontinue the use of options.[92] As a percentage of total executive compensation in the United States, options fell by 67% between 2001 and 2012.[93] By 2006, share grants made up the majority of CEO equity incentives used by the S&P 500.[94]

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[85] Ericson, *supra* note 64 at 28.

[86] Chowdhury, *supra* note 54 at 12.

[87] "Executive Compensation Principles" (January 2013), online (pdf): *Canadian Coalition for Good Governance* <ccgg.ca/wp-content/uploads/2019/03/Executive-Compensation-Policy-branding-update-2020.pdf> ("[w]here stock options are used, they should be de-emphasized in favour of other forms of equity-linked compensation" at 3).

[88] Tracy Tjaden, "Why Jarislowsky Thinks Stock Options are Dangerous", *The Globe and Mail* (8 December 2010), online: <www.theglobeandmail.com/report-on-business/careers/why-jarislowsky-thinks-stock-options-are-dangerous/article1318871/>.

[89] Allaire, *supra* note 15 at 54.

[90] *Ibid* at 24.

[91] Diane Doubleday & Jennifer Wagner, "New Era for Boards and Executive 'Pay for Performance'", *The Corporate Board* 30:178 (September 2009) 5 at 6.

[92] Ericson, *supra* note 64 at 23.

[93] Martin J Conyon, "Executive Compensation and Board Governance in US Firms" (2014) 124:574 Economic J F60 at F74.

[94] *Ibid*.

In Canada option use declined among the 60 largest public companies, although the decline was shallower and slower than the United States. As a percentage of total compensation, options declined by only 25% between 2000 and 2008—less than half the rate of the American decline.[95] For these large companies, options predominated among equity incentives until comparatively recently.[96] As a percentage of total CEO compensation, Canadian S&P 60 companies now issue options at more or less the same rate as American companies. The lower over-all use of equity incentives in Canada arises from lower use of share grants.[97]

The criticisms of stock options, made in the context of large public companies, was always going to have an effect on their use by even private growth companies. The investors, directors and managers of startups also tend to be involved in one capacity or another with larger firms and quickly became socialized in the failings of stock options. In reviewing the critiques of stock options found in the writings of academics, institutional investors, newspapers, and governance experts, I was unable to find a single instance in which private startups or growth companies (much less firms listed on Canada's public venture markets) were excepted from the criticisms. This has had the effect of putting pressure on these companies to reduce their use of options as well. Whereas twenty years ago it was common to see growth companies with option pools equal to 20 percent of their outstanding shares, they tend to be much smaller now.[98] In this way the turn away from stock options has reduced the currency available to startups to attract employees.

The situation of growth companies can be stated simply: as we have seen they make almost exclusive use of stock options, even though share grants are superior in many circumstances. Because of their dependence on stock options and the growing unpopularity of options, growth companies have come to face constraints on the amount of equity they can offer prospective employees.

IV. ARE CORPORATE GOVERNANCE FAILURES THE EXPLANATION FOR CANADIAN EQUITY COMPENSATION PRACTICES?

Because stock options tend to pay out more generously than other types of equity incentives, it is possible that their continuing use is strongly desired by managers and permitted by captured boards.[99] This assumed managerial appetite for risk contradicts, however, the other alleged governance failure surrounding equity incentives in

[95] Allaire, *supra* note 15 at 24.

[96] *Ibid*.

[97] *Ibid*.

[98] Tingle, *Start-up and Growth Companies in Canada, supra* note 28 at 174.

[99] Bryce C Tingle, "Framed! The Failure of Traditional Agency Cost Explanations for Executive Pay Practices" (2017) 54:4 Alta L Rev 899 at 901–03 [Tingle, "Framed!"].

Canada: the under-use of equity incentives generally.[100] According to proponents of this view, our executives have persuaded their boards to rely too much on relatively "safe" forms of cash compensation rather than riskier equity compensation that mirrors the long-term outcomes experienced by the shareholders. The remedy is for Canada to "embrace an incentive culture that includes stock options."[101] Surely, however, Canada can't be suffering from both governance failures—simultaneously too much, and too little, appetite for risk?

In fact, there are reasons to think the patterns of use of equity incentives in Canada is not due to failures of corporate governance. One of the most obvious is that, as the history of the use of equity incentives reveals, boards have generally proven to be extremely responsive to changing academic and governance fads.[102] Corporate boards adopted at-risk equity incentives when they were encouraged in the early 1990s, began abandoning stock options when encouraged a decade later, and no doubt will follow the next prescription for one-size fits all compensation practices promoted by the governance community.[103] In the UK, as we have seen, stock options have effectively been eliminated from CEO pay packages. In the United States, share grants are almost double the size of option grants (and when cash-settled equity-like incentives such phantom stock are added, they dwarf the once mighty stock option)[104] It would be odd if Canada, with its more conservative boards,[105] lower over-all executive pay,[106] and a greater proportion of companies with a controlling shareholder,[107] turned out to have materially weaker boards than the US or UK.

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[100] See discussion at notes 87–90.

[101] Pav Jordan, "Canada's Venture Sector Urged to Build on Success", *Financial Post* (27 May 2011), online: <financialpost.com/entrepreneur/fp-startups/canadas-venture-sector-urged-to-build-on-success>.

[102] This argument forms the subject of Tingle, "Framed!", *supra* note 99.

[103] See discussion at notes 87–90.

[104] PWC & NASPP, "2015 Global Equity Incentives Survey: Executive Summary" (August 2015) at 4, online (pdf): *PWC* <www.pwc.com/us/en/hr-management/publications/assets/2015-global-equity-incentives-survey.pdf>.

[105] Theresa Tedesco, "Executive Pay Has Soared to Record Highs in the US – But Don't Expect the Same Here", *Financial Post* (3 June 2014), online: <financialpost.com/executive/leadership/executive-pay-has-soared-to-record-highs-in-the-u-s-but-dont-expect-the-same-here> ("'There's a higher level of conservatism here,' explained a veteran Canadian corporate lawyer").

[106] *Ibid* (according to Rick Schubert, an associate partner at Aon Hewitt in Toronto, "'[i]t is the strongest single variable in terms of the correlation between a company and its CEO's pay ... they are running bigger companies in the U.S. and there are many more of them than here' which explains why U.S. CEOs tend to make 30% to 50% more than their Canadian counterparts").

[107] Randall Morck & Bernard Yeung, "Some Obstacles to Good Corporate Governance in Canada and How to Overcome Them" in *Canada Steps Up: Maintaining a Competitive Capital Market in Canada: Research Studies*, vol 4 (Toronto: Task Force to Modernize Securities Legislation in Canada, 2006) 279 at 287 (most large listed Canadian firms, like most large firms in Latin America, East Asia, and parts of continental Europe, have controlling shareholders); Marianne Bertrand & Sendhil Mullainathan, "Are CEOs Rewarded for Luck? The Ones Without Principals Are" (2001) 116:3 QJ Economics 901 at 920–24 (noting that the presence of a large shareholder leads to better corporate governance due to the idea that there is a principal to whom managers must answer); Donald C Hambrick & Sydney Finkelstein, "The Effects of Ownership Structure on Conditions at the Top: The Case of CEO Pay Raises" (1995) 16:3 Strategic Management J 175

There are reasons, in any event, to question the near-automatic assumption in the governance community that board capture and rent extraction are the best explanations for corporate pay.[108] No doubt this is true in some cases,[109] but it is not at all clear that it has general explanatory (and, therefore, predictive) power. Recent research has shown, for example, that private equity-backed companies with shareholder-dominated boards, pay their executives in a way that is "statistically indistinguishable" from the level of pay in widely-held public companies.[110] "[O]verall the evidence from private equity offers little direct support for the view that managerial influence leads to excessive CEO pay in public companies."[111] Both the quantum and the type of equity incentives provided to executives in the two sorts of firms are identical.[112]

Other research finds little evidence that increasing the proportion of independent directors on either the board or the compensation committee has any impact on the proportion of pay that is contingent on managerial performance.[113] Surely, if managerial power is a significant determinant of pay structure, increasingly independent boards and compensation committees should have some, even limited, impact on pay. But there appears to be none.

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at 176 (noting that externally-controlled firms with at least one major shareholder are presumed to be diligently monitored).

g[108] See Tingle, "Framed!", *supra* note 99; Mel Perel, "An Ethical Perspective on CEO Compensation" (2003) 48:4 J Bus Ethics 381 at 382 (suggesting that the source of excessive CEO compensation is more complicated than the relationship between CEOs and boards of directors).

[109] See e.g. Richard Siklos, "Conrad Black Found Guilty in Fraud Trial", *The New York Times* (14 July 2007), online: <www.nytimes.com/2007/07/14/business/13cnd-black.html>.

[110] Robert J Jackson Jr, "Private Equity and Executive Compensation" (2013) 60:3 UCLA L Rev 638 at 652.

[111] Ibid.

[112] *Ibid* at 655. The only significant difference the researcher found is that managers at private-equity backed companies are less likely to be able to cash-in their equity incentives than their public company counterparts. The confident conclusion: "[d]rawing on the lessons from private equity, public company directors … should pursue contractual arrangements that limit CEO's freedom to unload company stock" (*ibid* at 660). But this ignores the one great economic difference between private equity funds and public company shareholders: the latter can (and do) sell their shares in the short-to-medium term. Looking at the same data one could say that it suggests both groups of shareholders have successfully incentivized management to focus on maximizing returns over each group's unique investment time horizon.

[113] Katherine Guthrie, Jan Sokolowsky & Kam-Ming Wan, "CEO Compensation and Board Structure Revisited" (2012) 67:3 J Finance 1149 at 1165–66 (concluding that CEO pay levels are not affected by board independence, and that compensation committee independence only affects CEO pay levels in the presence of certain monitoring substitutes); Kam-Ming Wan, "Independent Directors, Executive Pay, and Firm Performance" (Paper delivered at the European Financial Management Association 2003 Annual Meeting, Helsinki, Finland, June 2003) [unpublished] (finding that both ownership and board structure have minimal effect on corporate pay); Catherine M Dailey et al, "Compensation Committee Composition as a Determinant of CEO Compensation" (1998) 41:2 Academy Management J 209 ("[w]e found no evidence of a systematic relationship between compensation committee interdependence and CEO compensation" at 215).

V. The Impact of Canadian Tax Policy on the Use of Stock Options

There is another explanation that accounts for Canada's under-use of equity incentives and its over-reliance on stock options: Canada's government has, for some reason, made the decision to privilege stock options and penalize stock grants. This has led to considerable difficulty in adopting share grants, particularly amongst Canadian growth businesses and, when combined with the governance industry's hostility against stock options, it has produced lower levels of equity incentives in this country generally.

Throughout most of the Twenty-First Century, Canada had one of the most generous regimes in the world in relation to stock options.[114] (Canada provides capital gains treatment for options so long as their exercise price is set at the fair market price of the underlying stock at the time of grant.[115] In contrast, it is much harder to achieve capital gains treatment under the American regime.)[116] The Canadian rules were never straightforward. Intended to assist small, cash-constrained entrepreneurial companies,[117] the regime was naturally so recondite that it required the assistance of expensive outside professionals.[118] (This self-defeating inefficiency is shared by the similarly targeted SR&ED and IRAP regimes.)[119]

From the standpoint of fostering the use of equity incentives for the startup companies that need it the most, the tax treatment of options for non-CCPC firms got a lot more counter-productive with extensive amendments in the 2010 Federal budget. Previously, the exercise of stock options resulted in a capital gain crystallizing, but this gain could be deferred until the underlying shares were sold.[120] This matched the moment tax was payable with the moment the employee sold her shares and received the money needed to pay the tax. The financial crisis of 2008, however, left large numbers of executives holding shares that were worth considerably less than when they had been acquired through the exercise of options. In many cases, the shares were

[114] Sandler, "Tax Treatment of Employee Stock Options", *supra* note 5 ("most employee stock options are taxed more favourably in Canada than in the United States... In particular, most employee stock option benefits in Canada are taxed at capital gains tax rates, whereas in the United States most are taxed at full rates" at 261).

[115] *ITA*, *supra* note 4, s 110(1)(d). Note that after January 1, 2020, options issued by all firms that are not CCPCs or "startups, emerging or scale-up companies" do not receive capital gains-like treatment if they exceed at $200,000 cap.

[116] Sandler, "Tax Treatment of Employee Stock Options", *supra* note 5 at 292–95.

[117] *Ibid* at 296–301.

[118] Tingle, *Start-up and Growth Companies in Canada, supra* note 28 at 166–69.

[119] See John Lester, "Benefit-Cost Analysis of R & D Support Programs" (2012) 60:4 Can Tax J 793 at 794 (describing how SR&ED and IRAP tax credit programs fail a cost-benefit analysis due to the high cost of administering and complying with the programs).

[120] *ITA*, *supra* note 4, s 180.01 as amended by *Sustaining Canada's Economic Recovery Act*, SC 2010, c 25, s 46.

worth less than the deferred tax bill due on their sale.[121] The government's response was not to change the rule that deems a capital gain to arise when an option is exercised (as opposed to having it arise when the underlying shares are sold[122]), but to remove the deferral.[123]

For all non-CCPC companies,[124] including startups listed on the TSX Venture Exchange and the Canadian Stock Exchange, tax is now calculated and due at the time the option is exercised.[125] The only rational choice for executives of these companies is to sell their shares immediately following the exercise of an option. Many of the shares will simply need to be sold to pay the tax. As well, the employee has an incentive to realize the gains on which they have just been taxed. An employee will be conscious of the risk of unfairness if she holds onto the shares for the long-term. If the price of the shares decline before she disposes of the shares (and the prices of growth companies are volatile), her tax bill on exercising the option may exceed the final value of the shares. Thus, a tax regime clearly designed to respond to the need of Canadian startups to have access to equity incentives has been revised to discourage precisely what everyone wants: the long-term holding of equity by managers.[126]

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[121] Alan Mcnaughton & Amin Mawani, "Contributions of Employee Stock Options to RRSPs and TFSAs: Valuation Issues and Policy Anomalies" (2008) 56:4 Can Tax J 893 (discussing the problem of "underwater" options at 907); Wayne Tunney, "Underwater Stock Options Sink" *Canadian Tax Highlights* 11:6 (June 2003) 1, online (pdf): <www.ctf.ca/ctfweb/Documents/PDF/Cdn_Tax_Highlights/2003CTH06.pdf>. See Murphy, "Pay, Politics, and the Financial Crisis", *supra* note 67 for a discussion of this phenomena in the US.

[122] This is in fact how options issued by CCPCs are treated: *ITA*, *supra* note 4, s 7(1.1).

[123] Gloria Geddes, "Canada: Equity Compensation Becomes Less Attractive Under Budget 2010" (22 March 2010), online: *Mondaq* <www.mondaq.com/canada/income-tax/96354/equity-compensation-becomes-less-attractive-under-budget-2010>.

[124] The CCPC regime is much more generous, but does not concern us here. No public companies can qualify as CCPC companies and many growth companies, particularly in the high technology sectors, offend at least one of the conditions of being a CCPC. See e.g. Ben Tomlin, "Clearing Hurdles: Key Reforms to Make Small Business More Successful" (May 2008) at 5, online (pdf): *CD Howe Institute* <www.cdhowe.org/sites/default/files/attachments/research_papers/mixed/commentary_264.pdf> (discussing the ways CCPC rules present difficulties for growth companies). See also Duanjie Chen & Jack Mintz, "Small Business Taxation: Revamping Incentives to Encourage Growth" (2011) 4:7 U Calgary School Public Policy Publications 1 (discussing the CCPC programme's creation of a "taxation wall" discouraging growth).

[125] See Ontario, Ministry of Finance, *Employee Stock Options* (Bulletin) (Oshawa: Ministry of Finance, January 2008), online: *Government of Ontario* <fin.gov.on.ca/en/bulletins/eht/0307.html> ("[a]ny taxable benefit resulting from an employee exercising stock options on securities that are not of a CCPC, including publicly-listed securities or securities from a foreign-controlled corporation, must be included in employment income at the time [that is, the tax year] the options are exercised").

[126] Similar perverse incentives arise around other forms of government-sanctioned compensation schemes such deferred stock units, or "DSUs." The regulations governing their use set very specific conditions under which a DSU may be paid out, some of which may not be relevant to a particular business and one of which, the requirement the employee depart before receiving the economic benefit of earlier grants, provides exactly the opposite incentive to those ideally created by an intelligently designed compensation scheme. See *Income Tax Regulations,* CRC, c 945, s 6801(d).

It might be objected that the Federal Government has attempted to address this problem by providing a tax regime for CCPC option grants that matches the taxable event to the date of disposition.[127] The problem is that CCPCs have always been a poor proxy for growth companies. This is implicitly acknowledged in the Federal Government's June 2019 Notice of Ways and Means on reforming the treatment of stock options as it expressly asks for public comment on how to identify non-CCPCs that are nevertheless growth companies.

The biggest problem with the CCPC regime is that it does not include growth companies listed on either of Canada's public venture markets. These markets typically deliver at least as much capital to early stage Canadian companies as institutional venture capitalists, and in some years more than six times as much.[128] Canada's public venture markets also have success rates (measured by both overall returns and new listings on the main market) that exceed those generated by domestic institutional venture capital by a significant margin.[129] They cannot be excluded by any tax policy seriously intended to foster startups.

Another problem with the CCPC regime is that many Canadian startups have a strong international flavour. They have founders resident in more than one country, or they have issued shares to acquire assets or technology developed in another country, or they have raised capital from angels, strategic investors, or venture capitalists in other countries. In aggregate, it is very easy for these sorts of companies, even if based in Canada and led by Canadians, to lose CCPC status because voting control no longer resides in the hands of Canadians. As they currently stand, the CCPC stock option rules exclude many of the growth companies it is intended to help.

However ill-fitting Canada's current stock option tax regime is for startup companies, at least it doesn't present an insuperable barrier to their use. In contrast, the tax regime's treatment of share grants simply makes them impossible. If shares are issued to an employee, the *Income Tax Act* requires the fair market value of those shares be immediately included in the employee's taxable income.[130] The consequence is that it is virtually impossible for a company to issue shares to executives unless the grant is very small or the executive is very rich (possibly as a result of simultaneous large cash bonuses). This may sound like a blow struck against

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[127] *ITA, supra* note 4, s 7(1.1).

[128] Cecile Carpentier & Jean-Marc Suret, "The Canadian Public Venture Capital Market" (2010) 19:7/8 Strategic Change 303 at 304.

[129] *Ibid* (noting that the TSX Venture Exchange has a success rate that is "approximately four times the corresponding rate for private VC" and that it provides seven times the number of TSX listings as Canada's VC firms. It also has a failure rate lower than that found in Canadian private VC portfolios). See also Michele Meoli et al, "Can Spending Time in the Minors Pay Off? An Examination of the Canadian Junior Public Equity Markets" (2018) 56:S1 J Small Bus Management 88 (showing that graduates from the TSX-V outperform VC-backed TSX companies by over 28 per cent in the first three years following their listing on the TSX).

[130] *ITA, supra* note 4, s 7(1).

corporate fat cats, but it actually means that growth companies seeking to recruit senior executives have no way of giving them a meaningful stake in the business, except through stock options. It also means that bonuses and long-term incentives come out of retained earnings, the most precious thing in the world to a fast-growing company. Indeed, as we have seen, only the largest Canadian companies can afford significant share grants.

Contrasting the situation in Canada with the tax regime in the United States is instructive. While the Americans have similar rules governing the tax treatment of share grants, the Internal Revenue Service has permitted the evolution of several strategies to deal with the problem. The first of these strategies is used primarily in private companies. Preferred shares are sold to third parties to finance the company while the common shares are deemed to have prices as low as one-tenth (or even as little as one-twentieth) of the value of the preferred shares.[131] This permits generous common share stock grants to new executives, with relatively small immediate tax consequences.

The relative valuation of the classes of shares (often there are more than one series of preferred share issued) is almost certainly a fiction. Generally, the preferred shares used in US financings convert into common shares on a one-to-one basis. As the company approaches a successful exit, such as an IPO, when the conversion of the preferred shares seems likely, the differences in value between the two classes of shares declines and eventually disappears.[132] Before this point the vast gulf in value between preferred and common shares is ostensibly due to the enhanced rights attached to those shares, in particular the preference in the event of liquidation.[133] The value of this right is dubious: "the priority rights attaching to preference shares are relevant primarily in the event of bankruptcy, at which time neither the preference shares nor the common shares would likely realize anything."[134] While it might be argued that the additional rights often embedded in the terms of the preferred shares, such as anti-dilution protection or redemption rights, contribute to the disparity in value, they are used too infrequently to be sufficient justification.[135]

It is generally agreed by scholars examining American valuation practices in this area that these valuations are primarily sustained by the IRS' refusal to challenge

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[131] See generally Ronald J Gilson & David M Schizer, "Understanding Venture Capital Structure: A Tax Explanation for Convertible Preferred Stock" (2003) 116:3 Harv L Rev 874 at 900–01, n 86.

[132] Tingle, *Start-up and Growth Companies in Canada, supra* note 28 at 153.

[133] Douglas J Cumming & Sofia A Johan, *Venture Capital and Private Equity Contracting: An International Perspective* (Burlington, Mass: Academic Press, 2009) at 5.

[134] See Sandler, "Tax Treatment of Employee Stock Options", *supra* note 5 at 295.

[135] See Tingle, *Start-up and Growth Companies in Canada, supra* note 28 at 349–50 (in practice, anti-dilution rights are rarely employed); Douglas J Cumming & Sofia A Johan*, Venture Capital and Private Equity Contracting*, 2nd ed (London, UK: Elsevier, 2014) at 425–26 (examining venture capital exits and finding only 17 out of 187 were redemptions/retractions).

them rather than by the economic fundamentals of the arrangements themselves.[136] There is no parallel assumption in this country that Canadian tax authorities will accede to significant valuation differentials between preferred and common shares. One economist contacted three tax lawyers in three different provinces on the question of whether common shares can be priced at a fraction of existing preferred shares and received widely varying answers.[137] The only thing they had in common was a distinct lack of confidence in the answers.

Most Canadian lawyers probably don't believe the CRA would accept US-style valuation differentials between classes of shares. The evidence for this is that unlike the United States, only a minority of growth company financings in Canada use preferred share structures.[138] In fact, the same American venture capital funds that use preferred share structures in the vast majority of their domestic investments, make less than one-quarter of their investments in Canada using these structures.[139] Given the centrality of the tax valuation benefits afforded common shares in explanations for American preferred share financing structures, we can only conclude that their absence in Canada means the professionals involved in growth company financings in this country don't believe the tax benefits are available here.[140]

The second device used in the United States to ameliorate the tax consequences of share grants is to issue equity to executives that is, either on its terms or under a separate agreement, subject to certain conditions. These are referred to as "restricted stock grants" and the most common conditions provide that the executive may not sell, transfer or pledge the shares until some milestone has been reached. The shares are often held in escrow by a third party to ensure compliance with the conditions of the grant. The conditions for release can consist of the achievement of individual or corporate performance targets or simply remaining employed by the company until a certain date.[141] Under US tax rules, the executive is not subject to tax

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[136] Victor Fleischer, "Taxing Founders' Stock" (2011) 59:1 UCLA L Rev 60 at 74–75, n 58.

[137] Douglas J Cumming, "United States Venture Capital Financial Contracting: Foreign Securities" in Mark Hirschey, Kose John & Anil K Makhija, eds, *Advances in Financial Economics: Issues in Corporate Governance and Finance*, vol 12 (Bingley: Emerald Group Publishing, 2007) 405 [Cumming, "United States Venture Capital Financial Contracting"]. See also Scott Ollivierre, "The Influence of Taxation on Capital Structure in Venture Capital Investments in Canada and the United States" (2010) 68:1 UT Fac L Rev 9 ("[t]here is no jurisprudence on point, and the CRA has not published any administrative practice in this regard, leaving it unclear how vigilant it is in enforcing the valuation of common shares at their true economic value" at 26).

[138] Douglas J Cumming, "Capital Structure in Venture Finance" (2005) 11:3 J Corporate Finance 550 at 552 (preferred equity made up only 7.27% of investments in their results).

[139] Cumming, "United States Venture Capital Financial Contracting", *supra* note 137 at 408.

[140] This is particularly the case given the many non-tax advantages preferred shares have over common shares in the context of financing entrepreneurial ventures. See Tingle, *Start-up and Growth Companies in Canada, supra* note 28 at 331–33.

[141] Stikeman Elliott LLP, *supra* note 51 at 22.

on the share grant until the restrictions lapse and even then an election can be made that effectively delays the taxable event until the shares are sold.[142]

The Canadian tax regime is not as patient. Restricted shares are taxed as income in the year they are issued.[143] The CRA will, however, permit a reasonable discount from the fair market value of the unrestricted shares. Based on one report of discussions with the Valuation Section of Toronto's Central Tax Services Office, "it appears that a discount in the range of 10% to 20% would generally be acceptable in the case of a 2 to 3 year holding period restriction."[144] Obviously this is not sufficient to materially reduce the tax penalty resulting from issuing shares to an employee.

It is a testament to the responsiveness of Canadian boards to evolving norms of corporate governance that share grants occur at all among growth companies on, say, the TSX Venture Exchange. It makes no sense to issue long-term compensation that requires its beneficiaries to pay tax today on stock that is illiquid, might be confiscated or cancelled, and could turn out to be valueless tomorrow. The tax regime in this country has thus made it challenging for companies to use stock options as their primary method of providing equity to employees.

Since stock options are held in aversion by most commentators on executive pay and corporate governance, Canadian companies issue less equity than their international peers. For Canada's largest companies this is an inconvenience. For the growth companies who need to be able to use their equity to attract talent, the situation constitutes one more drag on their growth prospects.

VI. The Equity Incentive Canadian Startups Need

There are a lot of things that could be done to fix Canada's rules around equity incentives. Now that it appears the favourable treatment of stock options will largely be confined to growth companies, perhaps the tax regime could change so the moment tax is calculated and paid coincides with the moment the cash to pay the tax is received. The current incentives created by Canada's tax rules around stock options are the opposite of what we would wish.[145]

It should be noted, incidentally, that the generalized antagonism towards stock options is probably overdone. Options do have the problems discussed earlier, but there is plenty of research suggesting options should never entirely disappear as a

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[142] IRC § 83(b).

[143] *ITA*, *supra* note 4, s 7(1).

[144] Julie Y Lee, "Stock Option Plans and Other Equity-Based Incentives" (Paper delivered at the 2010 Tax Law for Lawyers conference, 30 May–4 June 2010) [unpublished] at n 33, online (pdf): *Canadian Bar Association* <cba.org/cba/cle/PDF/Lee_Julie_Paper.pdf>.

[145] See earlier discussion at text accompanying notes 119–27.

component of executive compensation.[146] Managers have a tendency to be risk averse: their income, personal prestige and access to corporate perquisites depend on their continuing employment by the company. Options can be used to make managers more risk neutral (less risk averse), but the proper balance of options with share grants and other components of executive compensation will depend on the personality of the executive, her circumstances, and the company's business environment.[147] The Canadian government should maintain a tax policy that provides a way for growth companies to use stock options effectively.

It is even more important that the tax rules change to facilitate the ability of startups to use share grants as a means to attract the talent they require to compete on the international stage. Often this means trying to hire individuals with the necessary expertise who currently reside in jurisdictions that do make share grants possible. In some sectors, such as tech, nearly all the necessary experts will have spent at least part of their career working outside of the country. There are simply not enough large software companies in Canada, for example, that a startup is likely to find a Canadian resident with decades of experience in enterprise sales. If a Canadian company cannot match, and exceed, the equity incentives a potential employee has in other countries, they will not be able to build their business. They will, instead, do as well as they can, then sell the company—usually to a foreign buyer.

There is a kind of precedent in our tax regime for deferring the tax paid on a share grant. We grant rollover treatment for a large number of transactions in which shares are received by a resident, deferring the moment tax must be calculated and paid to the moment when the underlying equity interest is sold.[148] This analogy is not perfect, since rollover rules merely preserve a pre-existing tax basis, whereas deferring the tax due on the grant of shares involves ignoring the tax basis of the shares. However, the rollover rules do provide a relevant policy precedent as they exist because they are viewed as essential both for reasons of fairness (it is not fair to tax someone for a transaction that does not produce the means to pay that tax) and so as not to interfere with economically important transactions. Deferring the tax due on the grant of shares by a startup in appropriate circumstances, fits comfortably within

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[146] WM Gerard Sanders & Donald C Hambrick, "Swinging for the Fences: The Effects of CEO Stock Options on Company Risk Taking and Performance" (2007) 50:5 Academy Management J 1055 at 1074 (suggesting that without option incentives CEOs can tend to be *too* risk-averse); S Trevis Certo et al, "Giving Money to Get Money: How CEO Stock Options and CEO Equity Enhance IPO Valuations" (2003) 46:5 Academy Management J 643 at 650 (in the context of IPOs, CEO equity ownership combined with CEO stock options can lead to a better balance of proper risk taking); Kuntara Pukthuanthong, Richard Roll & Thomas Walker, "How Employee Stock Options & Executive Equity Ownership Affect Long-Term IPO Operating Performance" (2007) 13:5 J Corporate Finance 695 at 717 (finding that operating performance is better for firms with a balanced combination of equity ownership and stock options).

[147] David Larcker & Brian Tayan, *Corporate Governance Matters: A Closer Look at Organizational Choices and Their Consequences* (Upper Saddle River, NJ: Pearson Education, 2011) at 271–78.

[148] *ITA*, *supra* note 4, ss 85–87.

this logic. It is worth keeping in mind that the majority of growth companies fail, and the deferred taxable value of the shares will, in fact, be zero.[149]

What would a tax regime that allowed startups to grant shares to employees look like? First, it would apply only to Canadian growth companies. This would have to go beyond CCPCs, which are, as we have seen, a pretty poor proxy for the kind of startups we care about. [150]

The class of qualified companies would, for example, have to include firms listed on Canada's public venture exchanges, as well as companies fortunate enough to attract sizeable investments from foreign angels or venture capital firms. The federal government is currently in the process of determining how to define growth companies in relation to their stock option rules; there is no reason not to adopt their eventual definition.

To qualify, a share grant would have to be made to an employee and it would have to be subject to vesting conditions. Few bona fide share grants are made to employees on an unrestricted basis. Part of their purpose is to induce employees to stick with the business for a certain period of time, so at a minimum they always require some period of continuous satisfactory employment.

If there was still concern for the possibility of abuse, the tax regime could impose a further condition that the share grant be approved by an independent board of directors. Startups of the type we are interested in here tend to acquire independent boards quickly because of their dependence on external, arms-length sources of finance.

Objections can always be raised that any tax deferral scheme creates an expense to the taxpayer, but there are good reasons to believe that in this case, the objection is overblown. Because startups use stock options as equity incentives now, the public fisc should not be affected by permitting a deferral on qualified share grants. Share grants would simply substitute for what would otherwise be a stock option grant. Indeed, given that shares are subjectively seen by their recipients as more valuable than options, the total amount of equity on which the tax is deferred is likely to go down to the extent share grants supplant option awards.

It seems like a false economy to insist on a tax structure that creates significant barriers to growth of the most important class of businesses in our

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[149] Industry Canada, Fisher & Reuber, *supra* note 27 at 9 (only about half of all new Canadian firms survive five years).

[150] An example of what is to be avoided is the current CCPC and small business tax regime: Michael Wolfson et al, "Piercing the Veil: Private Corporations and the Income of the Affluent" (2016) 64:1 Can Tax J 1 (discussing the role of CCPCs in income inequality and finding that "as many as 80 percent of the taxfilers in the top 0.01 percent (one hundredth of a percent) were CCPC owners during this decade" at 11); Chen & Mintz, *supra* note 124 (finding "many small businesses are created to enable individuals to reduce personal tax rather than grow companies…" at 4).

country.[151] Facilitating the growth of the fastest growing, most innovative firms in Canada, should lead to greater tax revenues in much the same way that permitting economically efficient corporate transactions through the rollover regime in the long run benefits the public purse.

VII. CONCLUSION

The Federal government should not try to pick winners when it comes to compensation structures. The tax preference for options arose at the height of the corporate governance industry's enthusiasm for stock options in the 1990s, but remained on the scene long after this enthusiasm waned. There are circumstances where it is in the best interest of a company to use a variety of equity plans to manage employee incentives and recruit talent; government tax policy should be neutral on what sort of incentives are used.

A historical survey of European and American compensation practices found tax policies in various countries had a major impact on the ebb and flow of stock option grants.[152] The scholars found governments' reactions tended to closely follow isolated events and controversies and characterized policy making in this area as "knee-jerk."[153] Canada's government should resist the current fashion of denigrating options and move in the opposite direction to liberalize the tax regime—at least for growth companies—to permit executives to hold onto the shares purchased under an option long after exercise.

As well, this paper is not proposing something radical in relation to the taxation of share grants. The changes to the tax regime it suggests would merely put Canadian growth companies in the same position as their peers in the United States. The share grant regime there has existed for decades without creating intractable problems. It is hard to argue that it would be a mistake to emulate a small part of the regulatory regime that makes the US the most successful incubator of fast-growing and innovative businesses.

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[151] See earlier discussion at text accompanying notes 28–31.

[152] Martin J Conyon et al, "The Executive Compensation Controversy: A Transatlantic Analysis" (2011) Cornell University ILR School Institute for Compensation Studies Working Paper No 2011-002 at 111, online: *Institute for Compensation Studies* <digitalcommons.ilr.cornell.edu/cgi/viewcontent.cgi?article=1004&context=ics>.

[153] *Ibid*.