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Meridian Client Update

Hold the Date:
Meridian will be holding a breakfast briefing in Calgary on June 5th. Watch for additional information by email soon!

Director Compensation:
DSUs Require Canadian Directors To Hold Their Equity Until Retirement

Equity is an increasingly important component of director compensation and is designed to create alignment with shareholders and deliver competitive pay. A combination of good governance practices and limitations imposed on deferred share units (DSUs) under the Canadian Income Tax Act (ITA) may be locking directors into ever larger equity positions which cannot be monetized until retirement. Companies can consider alternatives to DSUs for directors who have met their share ownership requirements.

Director Equity Pay Trends

The following trends are continuing:

- The prevalence of director stock options is decreasing—As of 2012, only 1 company in the TSX 60 granted options to directors. This is down substantially from 10 years ago.
- An increasing portion of director compensation is provided in the form of equity—The median portion of retainer for board service provided as equity is approximately 50% for the TSX 60.
- Share ownership requirements for directors are also increasing—the median multiple at the TSX 60 is 3X annual retainer, but this is increasing at large U.S. companies to 5X annual retainer and increases are expected in Canada.

Director share retention requirements (beyond share ownership requirements) are not common in either Canada or the U.S. although many directors voluntarily hold equity until they leave the board.

The De Facto Hold Until Retirement Obligation in Canada

Canadian directors increasingly receive their equity in the form of DSUs. This is primarily a response to criticisms of stock option plans for directors by institutional shareholders and proxy advisors.

DSUs allow directors to defer tax on the equity portion of their compensation. However, in order to meet the deferral requirements under the ITA, DSUs cannot be redeemed until the director **retires** from the Board.

These tax rules impose a "hold until retirement" obligation on 100% of DSUs awarded to Canadian directors. The mandatory hold requirement also makes the decision to elect to receive more than the

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mandated portion of director compensation in DSUs an irrevocable one, as even compensation voluntarily deferred as DSUs is subject to the hold requirement.

Directors, particularly long standing directors, may find themselves in the position that they substantially exceed their share ownership requirements and have significant personal wealth invested in the shares of companies they serve. Yet, good governance practices require them to continue to increase their investment by receiving a significant component of their compensation in DSUs each year.

The Alternatives

There are some alternatives which solve the mandatory holding requirement inherent in director DSUs:

- **Share Awards**—directors can be awarded shares purchased on the market (or be required to apply the appropriate portion of their retainer to purchase shares). These shares can (subject to the company's share ownership requirements) be sold from time to time. However, shares are taxed at full income rates when received, even if they are subject to restrictions or hold requirements.
- **Treasury Restricted Share Units**—director equity can be provided through treasury restricted share units (RSUs). This type of plan requires shareholder approval, but provides an effective tax deferral, as treasury RSUs are not taxed until they are redeemed (regardless of when they vest) and can be while the director is still a member of the Board. A cash based RSU plan cannot be used as only "bonus" compensation is eligible for tax deferral under this type of plan.

Meridian Comment: The unintended effect of DSUs (a hold until retirement obligation) may become an issue for some board members. The only way for directors to monetize DSUs is to resign from the Board, which the vast majority of directors would be very reluctant to do. Companies should consider whether to provide alternative forms of equity compensation (market purchased shares or treasury RSUs) for directors who have met their share ownership requirements.

The ***Client Update*** is prepared by Meridian Compensation Partners. Questions regarding this Client Update or executive compensation technical issues may be directed to:

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