

National Exchanges Propose Rules for Compensation Committees

Recently, the New York Stock Exchange (“NYSE”) and the NASDAQ Stock Market (“NASDAQ”) proposed revisions to their listing standards regarding the independence of directors serving on board compensation committees and the independence of the advisers to such committees. The eventual approval of these proposals will complete the rulemaking required by Section 952 of the Dodd-Frank Wall Street Reform and Consumer Protection Act directing the Securities and Exchange Commission and the national securities exchanges to take steps to strengthen the independence of board compensation committees and their advisers. This action is intended to complement new

disclosure requirements concerning compensation consultant conflicts of interest which go into effect in 2013.

This Thoughtful Pay Alert summarizes the proposed listing standards changes of the NYSE and the NASDAQ, as well as the new conflict of interest disclosure requirements, and suggests steps that companies should consider as they prepare for these new requirements.

Background

One of the key compensation-related provisions of the Dodd-Frank Act is Section 952, which enacted new Section 10C of the Securities Exchange Act of 1934. This provision requires the national securities exchanges to adopt new

The Proposed Listing Standards on Compensation Committee and Committee Adviser Independence

For companies listed on the New York Stock Exchange

- ▶ In determining the independence of directors serving on the compensation committee, a company must consider the NYSE’s general “independence” requirements, as well as the sources of the director’s compensation and his or her “affiliate” status (if any)
- ▶ In assessing adviser independence, a compensation committee must consider the six factors identified by the SEC (see page 3 below)
- ▶ These changes are to be effective on July 1, 2013, although companies would have until the earlier of their first annual meeting of shareholders after January 15, 2014, or October 31, 2014, to comply with the director independence standards

For companies listed on the NASDAQ Stock Market

- ▶ The board of directors must have a standing compensation committee with at least two independent members and a formal written charter
- ▶ Compensation committee members cannot receive consulting, advisory, or other compensatory fees
- ▶ In determining the independence of directors serving on the compensation committee, a company must consider the NASDAQ’s general “independence” requirements, as well as the director’s “affiliate” status (if any)
- ▶ In assessing adviser independence, a compensation committee must consider the six factors identified by the SEC (see page 3 below)
- ▶ These change are to be effective on SEC approval, although companies would have until the earlier of December 31, 2014, or their second annual meeting of shareholders after the rules have been approved, to comply with the director independence standards

“Affiliate” Status from Share Ownership Does Not Preclude Independence

- ▶ Notably, both exchanges state that, in certain situations, it may be appropriate for affiliates, such as representatives of significant shareholders, to serve of the compensation committee as such ownership may align their interests with those of unaffiliated shareholders

National Exchanges Propose Rules for Compensation Committees (continued)

listing standards strengthening the independence of board compensation committees and the advisers to such committees. In June, 2012, the SEC implemented Section 952 (and Section 10C) by adopting Exchange Act Rule 10C-1.

Exchange Act Rule 10C-1 sets forth certain requirements pertaining to the board compensation committee, including the independence of committee members, the committee's authority to retain and be directly responsible for the advisers it retains, the committee's assessment of the independence of compensation consultants, legal counsel, and other advisers to the committee, and disclosure of any conflicts of interests concerning compensation consultants. Specifically, the rule directs the SEC to require the national securities exchanges to adopt listing standards that implement its requirements by prohibiting the listing of companies that do not comply with these requirements.

On September 25, 2012, the NYSE and the NASDAQ each filed proposed listing standards with the SEC to implement the requirements of Exchange Act Rule 10C-1. Generally, these proposals track the substantive content of Section 952 (and Exchange Act Rule 10C-1). The key aspects of the proposals are set forth below.

NYSE Proposed Listing Standards

Compensation Committee Independence

As proposed, companies listed on the NYSE would be required to consider the following factors in evaluating the independence of a director serving on the board compensation committee:

- the source of compensation of the director, including any consulting, advisory or other compensatory fees paid by the company to the director; and
- whether the director is affiliated with the company, a subsidiary of the company, or an affiliate of a subsidiary of the company.

These factors (which are identical to the factors set forth in Exchange Act Rule 10C-1) are to be considered in addition to the exchange's existing independence standards for directors generally. Interestingly, in the case of the "affiliation" factor, the NYSE notes that, rather than adversely affecting a director's independence, affiliate status resulting from share ownership may, in fact, align a director's interests with those of unaffiliated shareholders.

Assessing Compensation Consultant and Other Adviser Independence

Neither the NYSE nor the NASDAQ have proposed to elaborate on how the six factors to be considered in assessing the independence of a compensation consultant, legal counsel, or other adviser are to be applied. Consequently, board compensation committees are likely to tread cautiously in making this evaluation in the absence of clear guidance from the exchanges or the SEC.

We believe that, at least initially, compensation committees are likely to use the following reference points to guide their deliberations:

- ▶ **Provision of Other Services.** Currently, SEC rules require enhanced disclosure where a compensation consultant provides non-compensation-related services in excess of \$120,000 during the last completed fiscal year. Although not dispositive, some committees may use this "bright-line" threshold as the starting point for their evaluation.
- ▶ **Relationship of Fees to Overall Revenues.** While there is little, if any, precedent for assessing the impact of revenue concentration, we expect that committees will look to their company's prior practices in evaluating the potential disclosure of related person transactions to develop a framework for considering the significance of this relationship. As is typically the case, these analyses are likely to be very fact-intensive. For example, an initial determination that fees represent 3%–5% or more of an adviser's employer's total revenue may necessitate a more detailed consideration of the relationship, which will ultimately turn on the underlying facts. On the other hand, fee levels below these points are less likely to raise concern, particularly given that each factor is to be applied on a competitively neutral basis.
- ▶ **Business and Personal Relationships.** For most committees, this factor may present the greatest challenges, as the range of relationships that may need to be considered is potentially unlimited. Committees may find that their company's current framework for evaluating the independence of directors (as established by a combination of SEC rules and exchange listing standards) is a good starting point. In addition, the committee may seek out the company's previous experiences in evaluating the potential disclosure of related person transactions

National Exchanges Propose Rules for Compensation Committees (continued)

The proposal would also provide a “cure” period for any director serving as a compensation committee member who is currently considered “independent,” but who ceases to be independent for reasons outside of his or her control, as long as a majority of the members of the committee continue to be independent.

Committee Adviser Independence Assessment

As proposed, the board compensation committee of a company listed on the NYSE would be required to consider all factors relevant to the independence from management of a compensation consultant, legal counsel (other than in-house counsel), or other adviser before retaining or obtaining the advice of such an adviser, including the following six “independence” factors (which are the same six factors set forth in Exchange Act Rule 10C-1):

- the provision of other services to the company by the adviser’s employer;
- the amount of fees received from the company by the adviser’s employer, as a percentage of the total revenue of the employer;
- the policies and procedures of the adviser’s employer that are designed to prevent conflicts of interest;

- any business or personal relationship of the adviser with a member of the compensation committee;
- any stock of the company owned by the adviser; and
- any business or personal relationship of the adviser or the adviser’s employer with an executive officer of the company.

Although the board compensation committee would be required to conduct an independence assessment, as specified in Exchange Act Rule 10C-1 it would not be prohibited from engaging an adviser that is determined not to be independent.

Effective Dates

The NYSE is proposing that the changes to its listing standards would become effective on July 1, 2013. In the case of compensation committee independence requirements, however, companies would have until the earlier of (i) their first annual meeting of shareholders after January 1, 2014, or (ii) October 31, 2014 to bring their committee into compliance.

Preparing Your Compensation Committee for the New Requirements

Although the proposed revisions to the NYSE and NASDAQ listing standards are not yet effective, we believe that technology and life sciences companies should be considering the following actions now in anticipation of the 2013 proxy season:

1. **Committee Composition.** Since most publicly-traded technology and life sciences companies currently have board compensation committees comprised solely of independent directors, the proposals should not require any fundamental change in this area. However, you should review the composition of your compensation committee to identify all sources of compensation received by committee members and whether any affiliate relationships exist. NYSE companies should determine whether these relationships affect the independence of the identified director. NASDAQ companies should determine whether any committee members currently are receiving prohibited fees, as well as the effect of any affiliate relationships.
2. **Committee Charters.** You should review your existing compensation committee charter to ensure that it appropriately addresses the proposals dealing with committee responsibilities and authority and the engagement of committee advisers. NASDAQ companies should also take steps to adopt a formal written charter if they do not already have one in place.
3. **Compensation Consultant Conflict of Interest Disclosure.** You should begin preparing for the new proxy statement disclosure requirement by collecting and confirming the information necessary to determine whether your existing compensation consultant relationships create any “conflict of interest.” For this purpose, you should review the six factors to be considered in the pending committee adviser independence assessment, as well as any other relevant factors.
4. **Committee Adviser Independence Assessment.** You should begin to contact your other advisers to the compensation committee, if any, to determine whether any independence assessment will be required. You may also want to consider developing a formal approach for addressing this assessment on an annual basis, including adding an agenda item to the compensation committee’s annual calendar.

National Exchanges Propose Rules for Compensation Committees (continued)

NASDAQ Proposed Listing Standards**Compensation Committee Independence**

As proposed, companies listed on the NASDAQ would be required to maintain a formal board compensation committee comprised of at least two independent directors and to adopt a formal written committee charter. (Currently, NASDAQ-listed companies may have executive compensation decisions made by a formal board compensation committee or by a majority of the independent members of the board of directors. Also, NASDAQ-listed companies are not required to have a written charter.)

In addition, the proposals would prohibit a director serving on the board compensation committee from being independent if he or she received, directly or indirectly, any consulting, advisory, or other compensatory fee from the company, or an affiliate, except a fee for board or committee service. This proposed prohibition is consistent with the exchange's current prohibition on the receipt of ancillary fees imposed on members of the board audit committee.

Further, as proposed, in addition to complying with the NASDAQ's current listing standards on director independence, NASDAQ-listed companies would be required to consider whether a director has an affiliate relationship with the company, a subsidiary of the company, or an affiliate of a subsidiary of the company in assessing his or her independence. Notably, the NASDAQ states that, in certain situations, it may be appropriate for certain affiliates, such as representatives of significant shareholders, to serve on the board compensation committee.

Like the NYSE, the NASDAQ has not proposed any additional factors when making independence determinations for compensation committee members. As with the NYSE proposal, the NASDAQ proposal also provides for a "cure" period in the event that a director ceases to be independent due to circumstances beyond his or her reasonable control.

Committee Adviser Independence Assessment

As proposed, the board compensation committee of a company listed on the NASDAQ would be required to consider all factors relevant to the independence from management of a compensation consultant, legal counsel (other than in-house counsel), or other adviser before retaining or obtaining the advice of such an adviser, including the six "independence" factors described above. As in the case of

an NYSE-listed company, a board compensation committee would not be prohibited from engaging an adviser who was determined not to be independent.

Effective Dates

The NASDAQ is proposing that the changes to its listing standards regarding the responsibilities and authority of the board compensation committee, as well as the committee adviser independence assessment, would become effective upon SEC approval. The additional proposals, including the compensation committee independence requirements, would be effective upon the earlier of (i) their second annual meeting of shareholders following SEC approval, or (ii) December 31, 2014.

Compensation Committee Responsibilities and Authority

Both the NYSE and the NASDAQ are proposing to amend their listing standards to conform to the portions of Section 952 and Exchange Act Rule 10C-1 that specify the responsibilities and authority of the board compensation committee. These amendments would make clear that:

- the committee must have the ability to engage compensation consultants, independent legal counsel, and other advisers;
- the committee is to be directly responsible for the appointment, compensation, and oversight of any such adviser engaged by the committee; and
- the company must provide for appropriate funding, as determined by the compensation committee, for the payment of such advisers.

Conflict of Interest Disclosure

In addition to the substantive independence requirements described above, Section 952 of the Doff-Frank Act also required the SEC to adopt rules for the disclosure in any proxy materials for an annual meeting of shareholders of whether the work of any compensation consultant to the board compensation committee raised any conflict of interest and, if so, the nature of the conflict and how the conflict was being addressed. Earlier this year, the SEC adopted such rules which are effective for any proxy statement prepared in connection with an annual meeting of sharehold-

National Exchanges Propose Rules for Compensation Committees (continued)

ers at which directors will be elected that will take place on or after January 1, 2013.

Under these rules, the six factors to be used to assess the independence of a compensation consultant, legal counsel, or other adviser as set out in the proposed NYSE and NASDAQ listing standards are among the factors that should be considered in determining whether a conflict of interest exists. Further, this disclosure requirement is to apply to any compensation consultant whose work must be disclosed as part of a company's discussion of its processes and procedures for setting executive and director compensation, regardless of whether the consultant was retained by management or the board compensation committee and regardless of whether the work involved executive or director compensation.

SEC Approval Timeline

The SEC is soliciting comments on the proposed listing standards until mid-November 2012. The SEC has 45 days (or 90 days, if it so designates) from the date that notice

regarding the proposed listing standards is published in the Federal Register to approve or disapprove the proposals. Alternatively, the SEC may commence proceedings to determine whether the proposed listing standards should be disapproved. While it is difficult to predict how this process will play out, we expect that the proposed listing standards (or a revised version thereof) will be approved within the next three to four months.

Need Assistance?

Compensia has significant experience in helping companies understand the corporate governance listing standards and other requirements affecting the composition and operation of their board compensation committees. If you have any questions on the topics covered in this Thoughtful Pay Alert or would like assistance in assessing how these proposals are likely to affect your executive compensation program, please feel free to contact us. ■

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