

# Management Alert



## Executive Compensation Updates: NYSE AND NASDAQ Propose Independence Standards for Compensation Committees and Consultants and ISS 2013 Proxy Guidelines

On June 20, 2012, the U.S. Securities and Exchange Commission (the “Commission”) adopted final rules to implement requirements under Section 10C of the Securities and Exchange Act of 1934 (the “Exchange Act”), established by Section 952 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the “Dodd-Frank Act”).

The new rules require (1) the national securities exchanges to adopt listing standards regarding the composition and independence of listed issuers’ compensation committees, as well as the appointment, independence, compensation and oversight of listed issuers’ compensation advisers, and (2) all issuers subject to the Commission’s proxy rules to disclose conflicts of interest relating to their use of compensation consultants.

In accordance with the Commission’s final rules, each of the New York Stock Exchange (the “NYSE”) and the NASDAQ Stock Market (“NASDAQ,” and together with the NYSE, the “Exchanges”) have proposed amendments to their listing standards to address these Dodd-Frank Act mandated requirements.

In addition to the proposed rules of the Exchanges, MSCI RiskMetrics ISS (“ISS”) has published its 2013 Policy Updates to its Corporate Governance Standards that will be effective for the 2013 proxy season. The 2013 policy updates reflect changes to ISS pay for performance methodologies relating to the consideration of peer group data and realizable pay.

This management alert summarizes the proposed NYSE and NASDAQ listing standards and the ISS 2013 Policy Updates relating to pay for performance metrics.

### Compensation Committee Independence Requirements

The Commission rules require each member of the compensation committee (or another committee charged with the oversight of executive compensation) of an issuer listed on a national securities exchange to be a member of the listed issuer’s board of directors and to be “independent.” Because the Commission does not mandate an issuer establish a compensation committee (unlike an audit committee), the Commission requires the director independence rules to also apply to members of the board of directors who, in the absence of a board committee, oversee executive compensation matters on behalf of the board. In this alert, we use the term compensation committee to capture these individuals. The exchanges must develop definitions of “independence” after taking into consideration relevant factors including, without limitation:

- The sources of compensation of a director of a listed issuer, including any consulting, advisory or other compensatory fee paid by the listed issuer to such director; and
- Whether the director is affiliated with the listed issuer or a subsidiary or affiliate of a subsidiary of the listed issuer.

The Commission chose not to define “affiliate” thereby enhancing the exchanges’ flexibility in setting the standards for determining the relationships that would not be considered independent. The Commission also gives the exchanges the latitude to exempt certain relationships from the independence requirements.

## **NYSE Rules**

Currently, NYSE Rule 303A.05 requires each member of a listed company's audit committee to meet the test for independence under NYSE Rule 303A.01. The proposed amendments will supplement NYSE Rule 303A.05 to require a listed company's board of directors to consider all relevant factors that may be material to a director's ability to be independent from management when serving on the compensation committee. These factors must include:

- The source of any compensation received by the director (including any consulting, advisory or other compensatory fee paid by the issuer);
- Whether the director receives compensation from any source that would impair his or her ability to make independent judgments about compensation;
- Whether the director is an affiliated person of the issuer or any of its subsidiaries or affiliates of its subsidiaries; and
- Whether the director's ability to make independent judgments would be impaired as a result of any affiliate relationship because the director may be considered to be under the direct or indirect control of the issuer or its senior management or to have a direct relationship with members of senior management.

The NYSE proposals do not apply a look-back period, so any arrangements that would violate the proposals which are terminated before the rules become effective would not preclude a determination of independence.

The NYSE proposals also provide that if a compensation committee member ceases to be independent for reasons outside of that member's reasonable control, the company will have a period to cure non-compliance with the listing standards. The cure period extends to the listed issuer's next annual meeting or, if earlier, one year from the occurrence of the event triggering non-compliance. A majority of the committee members must remain independent during the cure period.

Under the NYSE proposals, smaller reporting companies will be exempt from the additional independence requirements for compensation committee members. Controlled companies, which are exempt from the independence requirements under current NYSE rules, will also remain exempt from the new rules under the proposals.

## **NASDAQ Rules**

Currently, NASDAQ Rule 5605(d) requires the compensation of an issuer's executive officers to be determined by either the full board of directors or a committee consisting of two or more directors who meet the test for independence under NASDAQ Rule 5605(a)(2). The proposed NASDAQ rules would mandate listed companies have an independent compensation committee to approve or recommend to the full board all executive compensation (the NYSE rules already require listed issuers to establish a compensation committee). The new rules will require the compensation committee to adopt a written charter and to review and assess the adequacy of its charter annually. The charter must expressly prohibit the chief executive officer from being present during deliberations or voting on his or her compensation.

As with the proposed NYSE Rules, the NASDAQ proposals require the board to consider any compensation received by a compensation committee member as well as any affiliations of that member in determining his or her independence. However, the NASDAQ proposed rules go beyond the NYSE proposals by expressly prohibiting a compensation committee member from accepting, directly or indirectly, any consulting, advisory or other compensatory fees from the issuer or any of its subsidiaries, other than customary fees for board service or fixed income amounts under a retirement plan for prior service with the company. The NASDAQ proposals indicate that the service of directors affiliated with significant stockholders is permissible because their interests would be aligned with the interests of other stockholders.

Like the NYSE proposals, the NASDAQ proposals do not apply a look-back period, so any arrangements that would violate the proposals which are terminated before the rules become effective would not preclude a determination of independence. And, the NASDAQ proposes the same opportunity to cure as the NYSE proposals.

The NASDAQ proposals also provide for non-independent compensation committee members in exceptional and limited circumstances. If the compensation committee consists of at least three members and one director does not meet the independence requirements, so long as such director is neither an executive officer, nor a family member of an executive

officer, such director may be appointed to the compensation committee if the board, under exceptional and limited circumstances, determines that such appointment would be required by the best interests of the company and its stockholders. A director may not serve for more than two years in reliance upon this exemption and the company must disclose that it is utilizing this exemption in both its proxy statement and on its website.

Under the NASDAQ proposals, smaller reporting companies will be subject to the compensation committee composition requirements, but will be exempt from the additional independence requirements for compensation committee members. Controlled companies, which are exempt from the independence requirements under current NASDAQ rules, will remain exempt from the new rules under the proposals.

## Retention of Compensation Advisers

The Commission rules permit listed issuers' compensation committees, in their sole discretion, to retain or obtain the advice of compensation advisers, including compensation consultants, independent legal counsel and/or other advisers ("Compensation Advisers"). Under both the NYSE and NASDAQ proposed rules, compensation committees (or in the absence of a compensation committee, those directors who oversee executive compensation matters) will be directly responsible for the appointment, compensation and oversight of the work of any Compensation Advisers (though they are not required to follow such advisers' recommendations). Both Exchanges also propose that listed issuers will be required to provide appropriate funding to cover the payment of reasonable compensation, as determined by the compensation committee, to any Compensation Advisers the compensation committee retains.

## Consultant Advisor Independence Considerations

Before engaging any Compensation Advisers, the proposed rules of both Exchanges mandate that the compensation committees consider the following factors that the Commission rules identified for assessing the independence of Compensation Advisers. The factors mirror those set by the SEC in its final rules:

- The provision of other services to the listed issuer by the employer of the Compensation Adviser;
- The amount of fees the employer of the Compensation Adviser, as a percentage of such employer's total revenue receives from the issuer;
- The policies and procedures of the employer of the Compensation Adviser that are designed to prevent conflicts of interest;
- Any business or personal relationship of the Compensation Adviser with a member of the compensation committee;
- Any stock of the applicable listed issuer owned by the Compensation Adviser; and
- Any business or personal relationships between the executive officers of the listed issuer and the compensation adviser or the person employing the adviser.

Neither Exchange added any additional factors to be considered, although the NYSE proposal expressly contemplates that any other relevant factors should be considered. Neither of the Exchanges proposed to prohibit a compensation committee from engaging a Compensation Adviser that is not independent. Although, disclosure of any conflicts of interest with Compensation Advisers would be subject to proxy disclosure under the Commission rules that added new Item 407(e)(3)(iv) of Regulation S-K.

In addition, both Exchanges also propose to exempt smaller reporting companies and in-house legal counsel from the Compensation Adviser independence rules.

## Next Steps

The Commission's final rules require the Commission to approve the Exchange rules no later than June 27, 2013. If approved, both the NYSE and NASDAQ proposals provide that listed companies will have until the earlier of their first annual meeting after January 15, 2014 or October 31, 2014 to comply with the new rules. The NASDAQ proposal provides that the provisions relating to the authority and responsibility of the compensation committee regarding the selection

and compensation of advisers will be effective on July 1, 2013. For a quick reference guide to understanding the new independence standards for compensation committee members and a comparison to the audit committee independence standards, please see the table that is included at the end of this alert.

## ISS 2013 Policy Updates

ISS assesses executive compensation based on a pay for performance model that analyzes executive compensation with respect to three quantitative factors and qualitative considerations that focus on total shareholder return and peer group performance over one, three and five year periods. ISS pay for performance evaluation begins with a preliminary quantitative screen of company's pay and performance relative to a peer group selected by ISS based on the company's 6-digit GICS industry classification. A significant criticism of the ISS methodology is that a company's six digit GICS industry classification may not reflect multiple business lines in which many companies operate or may include companies that are not direct competitors of a company. ISS has acknowledged that this methodology has resulted in the inclusion of peer companies that may not have been appropriate for pay for performance comparisons.

The new methodology that ISS intends to use for the 2013 proxy season will focus initially on an 8-digit GICS resolution to identify peers that are more closely related to a company. ISS also will consider information from a company's self-selected peer group as set forth in its proxy statement in order to identify and prioritize companies in the ISS-selected peer group. When selecting peers, ISS will prioritize peers that maintain a company near the median of the peer group, are in the company's 8-digit GICS peer group, and that have chosen the company as a member of its peer group. The overall objective of the ISS peer group methodology remains to identify a set of peer companies reasonably similar to a subject company in terms of industry profile, size, and market capitalization. Although the changes to the ISS methodologies are a good start, they will not address all of the deficiencies in the ISS model. For example, under the ISS model, a company with a full in-house management team may still be grouped with peer companies that are managed completely by third party entities, which can result in significantly skewed compensation comparisons. In addition, a stand-alone public company also may end up grouped with an independently traded public company that is part of a large conglomerate of affiliated companies that would not take into account the effects of intra-company transactions by or among those affiliates.

ISS also is adjusting its pay for performance model for the 2013 proxy season to take into account realizable pay. While grant date pay reported in the proxy statement in accordance with Commission rules shows the intent of the pay decisions and the value at the time of an award, it does not necessarily reflect the final payouts of performance-based awards or changes in value due to gains or losses in a company's stock price. Accordingly, ISS is adding realizable pay as a factor that it will consider in assessing pay for performance of large capitalization companies. Realizable pay will consist of the sum of relevant cash and equity-based grants and awards made during a specified performance period being measured, based on equity award values for actual earned awards, or target values for ongoing awards, calculated using the stock price at the end of the performance measurement period. In other words, rather than looking at the grant date value of awards as reported in the Summary Compensation Table in a company's proxy statement, ISS will look to the value of awards upon vesting or exercise as reported in the Option Exercise and Stock Vested Table in the proxy statement.

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AUDIT COMMITTEE				COMPENSATION COMMITTEE		
	SEC	NYSE	NASDAQ	SEC	NYSE	NASDAQ
Authority	Section 10A(m), Exchange Act - Rule 10A-3(b)	Rule 303A.01	Rule 5605(a)(2)	Section 10C, Exchange Act - Exchanges consider factors	Amendments to Rule 303A.01	<ul style="list-style-type: none"> <li>• Rule 5605(a)(2) - current independence standards</li> <li>• Proposed Rule 5605(d)(3)</li> </ul>
Committee Requirement	No audit committee requirement	Audit committee is required	Audit committee is required	No compensation committee requirement	Compensation committee is required	Compensation committee will be required <ul style="list-style-type: none"> <li>• Charter required; annual review for adequacy</li> <li>• CEO cannot be present in deliberations or voting on compensation</li> </ul>
Standards	Unless the full board of directors has been designated as the audit committee pursuant to Section 3(a)(58), all committee members must be independent after considering compensation, fees and affiliations	No material relationship between the director and the company	No relationship that would interfere with the exercise of independent judgment in carrying out the responsibilities of a director	Exchanges develop independence standards; factors (principles-based): <ul style="list-style-type: none"> <li>• Sources of director's compensation, including fees issuer pays to director for consulting, advisory or other compensatory fees</li> <li>• Director's affiliations with issuer or its subsidiaries or affiliate</li> </ul>	<ul style="list-style-type: none"> <li>• Sources of compensation (including consulting, advisory or other fees)</li> <li>• Whether fees would impair ability to make independent judgments on compensation</li> <li>• Whether director is an affiliated person of the issuer, its subsidiaries or affiliates of subsidiaries</li> <li>• Whether affiliate relationships would impair ability to make independent judgments due to direct/indirect control of senior management or to have direct relationship with management</li> </ul>	<ul style="list-style-type: none"> <li>• Same as NYSE</li> </ul>
Prohibitions	Absolute prohibitions: <ul style="list-style-type: none"> <li>• No compensation or fees other than for board service</li> <li>• No affiliations with issuer or its subsidiaries or affiliates</li> </ul>	Same as SEC Rules	Same as SEC Rules	No express prohibitions	No express prohibitions	Cannot accept, directly or indirectly, any consulting, advisory or other compensatory fees from issuer or subsidiaries except customary fees for board service or fixed amounts under a retirement plan for prior service
Permissible Relationships	No express permissible relationships	Same as SEC Rules	Same as SEC Rules	No express permissible relationships	No express permissible relationships	<ul style="list-style-type: none"> <li>• Service of directors affiliated with significant shareholders permissible because interests are aligned with other shareholders</li> <li>• Non-independent members permitted in exceptional and limited circumstances</li> </ul>
Cure Period	None - permits exchanges to establish cure periods	Earlier of next annual meeting or one year from triggering event	Same as NYSE	Not applicable	Earlier of next annual meeting or one year from triggering event to cure	Same as NYSE
Effective	In effect	In effect	In effect	Approve Exchange rules by June 27, 2013	If approved, comply by earlier of first annual meeting after: <ul style="list-style-type: none"> <li>• January 15, 2014 or</li> <li>• October 31, 2014</li> </ul>	If approved, comply by earlier of: <ul style="list-style-type: none"> <li>• Second annual meeting after Commission approves rules or</li> <li>• December 31, 2014</li> </ul>