

Client Alert

April 17, 2013
(Updated from October 8, 2012)

NYSE/Nasdaq Change Compensation Committee and Adviser Independence Standards

No Surprises, but Nasdaq Companies Must Act Quickly to Adopt or Amend Committee Charters and Assess Adviser Independence

Executive Summary

The NYSE and the Nasdaq filed, and the SEC finalized, proposed changes to their listing standards that for the most part closely track most of the earlier guidance around the independence of Compensation Committee members and Committee advisers issued by the SEC under the 2010 Dodd-Frank Act. As directed, the Exchanges addressed three key areas that are collectively referred to as the Independence Rules. There were no big surprises in the issuance of these proposed changes, but important alterations are highlighted below.

- **Compensation Committee Independence¹:** Dodd-Frank requires that all Compensation Committee members satisfy independence standards established by the Exchanges, including an assessment of the compensation and affiliations of outside Directors. The NYSE added no additional modification or bright-line bars in those areas. The **Nasdaq, however, added a modification to prohibit an independent Compensation Committee member from receiving any compensation other than Director fees and fixed amounts under the Board's retirement plans. Nasdaq companies will now also be required to maintain a formal Compensation Committee consisting of at least two independent members.**
- **Compensation Committee Roles and Responsibility:** Under Dodd-Frank, companies must follow Exchange listing standards requiring that the Committee: (1) have sole authority to retain compensation advisers, (2) be responsible for the appointment, compensation and oversight of adviser work, and (3) be provided with adequate funding for such services. The NYSE already requires that Committees have a charter in place that substantially addresses these roles. **Nasdaq companies, however, are now required to have a formal written charter that addresses its responsibilities. This rule is effective on July 1, 2013.**
- **Adviser Independence:** The SEC also directed the Exchanges to issue listing standards requiring a Committee's outside advisers (not including in-house counsel) to be independent based on at least six enumerated factors. The Exchanges did not identify any other specific factors that must be considered, but emphasized that

¹ This Client Alert covers Committee independence as now required by the Exchanges. Companies should also consider the different independence requirements under Section 162(m) of the Internal Revenue Code, Section 16 of the Securities Exchange Act of 1934 and ISS and Glass Lewis, as applicable.

Committees should address *all* factors relevant to adviser independence. ***This rule is effective on July 1, 2013.***

This Client Alert discusses these three key areas, tracing the evolution of the regulations from the Act, to the SEC Final Rules and now the Exchanges' Changes. We provide a chart at the end of this Alert that details the similarities and differences among the guidance, as well as an update to our evolving timeline for implementation of all the compensation-related provisions under Dodd-Frank.

Background and Timing

The Dodd-Frank Act was signed into law on July 21, 2010. The SEC, in accordance with Section 952 of the Act, subsequently issued its Final Rules for Compensation Committee and Adviser independence on June 27, 2012. The next step in the regulatory process required each of the Exchanges to develop detailed listing rules in line with the new SEC standards. The Exchanges' Proposed Changes were issued September 25, 2012 (with minor amendment issued by the NYSE on October 1, 2012 relating to effectiveness) and approved by the SEC on January 16, 2013.

Compliance with the new rules will generally be required as follows:

	NYSE	Nasdaq
Compensation Committee Independence	The earlier of: (1) the first annual meeting after January 15, 2014, or (2) October 31, 2014	The earlier of: (1) the first annual meeting after January 15, 2014, or (2) October 31, 2014
Compensation Committee Roles and Responsibility	July 1, 2013	July 1, 2013
Adviser Independence	July 1, 2013	July 1, 2013

Compensation Committee Independence

The Dodd-Frank Act

Dodd-Frank prohibits listing companies on the Exchanges if their Compensation Committees do not conform to the new standards for Committee member independence. Those standards are based on, but not limited to, two considerations:

- Sources of any additional compensation paid to Committee members by the company, including consulting, advisory or other compensatory fees (the Compensation Test); and
- Whether any Committee members are affiliated in any way with the company, its subsidiaries or its affiliates (the Affiliation Test).

SEC Rules

The SEC clarified that the Compensation and Affiliation Tests provided under Dodd-Frank were for the two Exchanges' consideration. It offered no bright-line prohibitions and stated that the Act does not compel a company to maintain a Compensation Committee. The SEC did, however, expand the independence requirements to any Director who, in the absence of a Compensation Committee, oversees executive compensation matters on behalf of the Board. At the time the SEC issued its rules only the NYSE required listed companies to maintain a Compensation Committee, although the Nasdaq required that executive compensation decisions be approved either by a Compensation Committee or a majority of the Board's independent Directors.

NYSE Changes

Under previous NYSE rules a Director is considered "independent" for general Board service only if the Board affirmatively determines that he or she has no other material relationship with the listed company. The NYSE also maintains five bright-line prohibitions that would disqualify the Director as independent:

- The Director is (or has been within the last three years) an employee, or an immediate family member, is (or has been within the last three years) an executive officer of the company;
- The Director or immediate family member received more than \$120,000 in direct compensation (other than Director and committee fees and pension or other deferred compensation) that was not contingent on continued service during any 12-month period within the last three years;
- The Director: (1) is a current partner or employee of the company's internal or external auditor; (2) has an immediate family member who is either a partner of such a firm or an employee who personally worked on the company's audit; or (3) has, or has an immediate family member who has, served as a partner or employee of such a firm and personally worked on the company's audit within the last three years;
- The Director (or immediate family member) is or was employed within the last three years as an executive officer of another company while any of the company's present executive officers were serving on that company's Compensation Committee; or
- The Director is currently an employee (or has an immediate family member who is an executive officer) of a company that has made payments to or received payments from the company for property or services in any of the last three fiscal years that exceeds the greater of \$1 million or 2% of the other company's consolidated gross revenues.

The NYSE offered little additional guidance regarding the new Compensation and Affiliation Tests for assessing Committee member independence. For these Committee-specific tests, NYSE essentially directed Boards to consider whether any outside compensation or affiliation would impair the Director's ability to make independent judgments about executive compensation. Like the SEC, the NYSE specifically declined to delineate any specific standards for these two factors, reasoning that its five bright-line tests for general Director independence, in addition to a facts-and-circumstances consideration of the two new factors, should suffice. Like the SEC, the NYSE also emphasized that ownership of a significant amount of stock is not, in itself, a bar to independence. To the contrary, the NYSE expressed its view that share ownership aligns Directors with other shareholders' interest in ensuring that executive compensation is not excessive.

Nasdaq Changes

Like the NYSE, the Nasdaq maintains its own list of seven bright-line tests to determine if a Director is independent for general Board service. Nasdaq rules provide that any of the following would disqualify the Directors' independence:

- Being a current executive officer the company;
- Being (or at any time during the past three years) an employee of the company;
- Accepting, or having a family member who accepted, any compensation from the Company in excess of \$120,000 during any 12 consecutive months within the previous three years;
- Being a family member of an individual who is, or at any time in the past three years was, an executive officer of the company;
- Being, or having a family member who is, a partner, controlling shareholder, or executive officer of any organization that received from, or made payments to, the company for property or services in the current (or any of the past three fiscal years) that exceed 5% of the recipient's consolidated gross revenues for that year or \$200,000, whichever is greater;
- Being, or having a family member who is, an executive officer of another entity where any of the executive officers of the company served on the Compensation Committee of the other entity at any time during the past three years; or
- Being, or having a family member who is, a current partner of the company's outside auditor, or was a partner or employee of the company's outside auditor who worked on the Company's audit at any time during any of the past three years.

The Nasdaq took this opportunity to reassess its current rules regarding compensation governance. It determined that going forward, its listed companies will be required to have a formal Compensation Committee consisting of at least two members, each of whom must be an independent Director. ***In discussing the two new factors for assessing the independence of Committee members, the Nasdaq offered significant guidance on the Compensation Test. Specifically, any Director who accepts from the company or any of its subsidiaries, directly or indirectly, any consulting, advisory or other fees (other than Director and committee fees and pension or other deferred compensation) that is not contingent on continued service will not be considered independent for service on the Compensation Committee.*** The Affiliation Test, however, will remain facts-and-circumstances, taking into consideration whether such affiliation would impair the Director's judgment as a member of the Compensation Committee. Like the NYSE, Nasdaq emphasized that ownership of a significant amount of stock is not in itself considered a bar to independence.

The Nasdaq maintained its existing exception, which allows certain non-independent Directors to serve on a Compensation Committee for up to two years under exceptional-and-limited circumstances, provided the Committee consists of at least three members and the non-independent Director is not an executive.

Compensation Committee Roles and Responsibilities

The Dodd-Frank Act

Under Sections 952(c), (d) and (e) of the Act:

- Compensation Committees have sole authority to retain or obtain advice from compensation advisers, including consultants or legal counsel;
- Compensation Committees are directly responsible for the appointment, compensation and oversight of the advisers' work; and
- Companies must provide appropriate funding for the payment of reasonable compensation to such advisers as determined by the Compensation Committees.

Dodd-Frank also states that a Compensation Committee is not required to implement or to act consistently with any advisers' advice or recommendations, and that members retain the ability and obligation to exercise their own judgment in fulfillment of the Committee's duties.

SEC Rules

The SEC expanded responsibility for the appointment, compensation and oversight of the advisers' work to any Director who, in the absence of a Compensation Committee, oversees executive compensation matters on behalf of the Board. It also clarified that the Committee's responsibility for ensuring independence does not apply to advisers retained by management.

NYSE Changes

The NYSE notes that while most of the Committee responsibilities under Dodd-Frank are already included in its listing rules, the new rules amend the listing standards to more closely track the language used in Dodd-Frank. The Exchange also stated explicitly that the Compensation Committee will not be required to implement or act consistently with the advice or recommendations of these advisers, and retains the ability and obligation to exercise its own judgment in fulfillment of its duties.

Nasdaq Changes

Going forward, Nasdaq companies will be required to adopt a written Compensation Committee charter that specifies:

- The scope of the Committee's responsibilities and how they will be carried out, including structure, processes, and membership requirements;
- The Committee's responsibility for determining, or recommending to the Board, compensation for the CEO and other executives;
- That the CEO may not be present during voting or deliberations on his or her compensation;
- The Committee's authority to retain compensation consultants, independent legal counsel and other compensation advisers; and

- The authority to fund such advisers.

Companies will also be required to annually review the adequacy of their Compensation Committee Charters.

Compensation Committee Adviser Independence

The Dodd-Frank Act

While Section 952(b) does not require that compensation consultants, legal counsel and other advisers to the Compensation Committee be independent, it directs the SEC and Exchanges to consider at least five factors in assessing adviser independence:

- Other services provided by the adviser's firm to the company;
- Fees paid by the company to the adviser's firm as a percentage of the advisory firm's total revenue;
- Policies or procedures maintained by the adviser's firm to prevent a conflict of interest;
- Any business or personal relationship between the adviser and a Compensation Committee member; and
- Any company stock owned by the adviser.

The Act clarifies that in considering these five factors, the SEC should be competitively neutral among different categories of consultants, counsel and other advisers.

SEC Rules

The SEC Rules included a sixth factor to be considered in an independence assessment:

- Any business or personal relationships between the executive officers of the company and the compensation adviser or adviser's firm. This would include situations in which the CEO and the compensation adviser are family members, or the CEO and adviser (or the adviser's employer) are business partners.

The SEC Rules also clarified that Compensation Committees must consider these six independence factors before consulting with, or obtaining advice from, outside legal counsel.

NYSE & Nasdaq Changes

While neither Exchange provided specific additional considerations to assess adviser independence, they cautioned that any other factors considered relevant to independence should be considered.

Exemptions from Independence Rules

The Dodd-Frank Act

Dodd-Frank exempted controlled companies (defined as a company that holds an election for the Board in which more than 50 percent of the voting power is held by an individual, group, or other company) from compliance with all Independence Rules.

The Act also specifically exempted the following categories of registered companies from its Compensation Committee Independence rules: (1) limited partnerships; (2) companies in bankruptcy; (3) open-end management investment companies registered under the Investment Company Act of 1940; (4) any foreign private issuer that discloses in its annual report why it does not have an independent Compensation Committee; and (5) any further exemptions deemed appropriate by the Exchanges, based on company size or other factors.

SEC Rules

The Final Rules adopted the specific exemptions above, and also provided that “smaller reporting companies” (those with public float of less than \$75 million) would be exempted from all Independence Rules.

NYSE Changes

The NYSE Changes provides that the exemptions listed above will apply to all of the Independence Rules. It also adds to the list of exempted entities: (1) passive business organizations in the form of trusts (such as royalty trusts); (2) derivatives and special purpose securities; (3) any company whose only listed equity security is preferred stock; and (4) foreign private issuers that follow home country practice. The NYSE confirmed that smaller reporting companies will be exempt from the Compensation and Affiliation Tests, as well as the standards for independent advisers. However, such companies must still maintain a formal Compensation Committee (as it had required in the past) and charter specifying Committee responsibilities.

Nasdaq Changes

The Nasdaq provides that its existing exemptions from compensation-related listing rules are also applicable to all Independence Rules under the Act, specifically: (1) asset-backed issuers and other passive issuers; (2) cooperatives; (3) limited partnerships; (4) management investment companies; (5) controlled companies; and (6) foreign private issuers that follow home country practice and disclose in their annual report why they do not have an independent Compensation Committee. The Nasdaq confirmed that smaller reporting companies will be exempt from the Compensation and Affiliation Tests for assessing Committee independence, as well as the standards for independent advisers. Such companies must, however, still maintain a formal Compensation Committee and charter (or Board resolution specifying the Committee’s responsibilities).

Cure Periods

The Dodd-Frank Act

The Act states that the Exchanges must provide a reasonable opportunity to cure any defects in Compensation Committee membership before delisting occurs.

SEC Rules

The SEC Rules reiterated the cure requirement and specified that the Exchanges must provide rules allowing for a reasonable opportunity for companies to address compliance issues. It suggested that the Exchange rules may provide that if a Compensation Committee member ceases to be independent for reasons outside the member's reasonable control, that person (with notice by the company to the Exchange) may remain on the Committee until the earlier of the next annual meeting or one year from the date on which the Director ceased being independent.

NYSE Changes

The NYSE narrowed the scope of the suggested SEC cure provision for members who cease to be independent for reasons outside their reasonable control. The Exchange allows the person to remain on the Committee until the earlier of the next annual meeting or one year from the date on which the Director ceased being independent, but ***only if the Committee continues to have a majority of independent Directors***. The NYSE reasons that this would ensure that the Committee could not take any action without the agreement of one or more independent Directors.

Nasdaq Changes

The Nasdaq provides that if a company violates the Compensation Committee composition requirements due to one vacancy, or one Compensation Committee member ceases to be independent due to circumstances beyond the member's reasonable control, the company has an opportunity to cure until the earlier of the next annual meeting or one year from the date on which the Director ceased being independent. If the annual meeting occurs no later than 180 days following the event that caused the noncompliance, however, the company instead would be given 180 days from the event to cure. A company relying on this provision would have to notify the Nasdaq immediately upon learning of the event or circumstance that caused the noncompliance.

Conclusion

Both Exchanges essentially tracked guidance issued under the Act and subsequent SEC materials. Certainly, the NYSE guidance was more of a non-event than the Nasdaq guidance, which now requires Nasdaq listed companies to have a formal Compensation Committee and charter, as well as prohibits Committee members from receiving any outside fees from the company.

We recommend companies take the following actions in light of this latest regulatory guidance:

- Take action if your company does not currently have a Compensation Committee of at least two independent Directors or a formal charter, and review the independence status of Compensation Committee members and/or any other Directors involved in executive compensation decision-making. Determine which Directors would fail to be independent under the enumerated independence tests.
- Ensure that the Compensation Committee Charter provides the necessary authority, responsibility and funding for advisers.
- Review any Committee engagement letters with compensation advisers to ensure the Committee is directly responsible for appointing, compensating and overseeing the adviser.
- Review your consultant's and other adviser's independence. Run the six-part conflict test (which is effective on July 1, 2013) on your compensation consultants and outside legal advisers. While Committees are not prohibited from using non-independent advisers, they should be prepared to explain the need to retain such advisers – particularly compensation consultants whose conflicts will be subject to disclosure.
- If your compensation consultant "fails" any of the conflict tests, be prepared to disclose why the engagement was continued and why the conflict did not affect the adviser's independence or advice.
- Remember that the implementation dates of the Exchange listing rules do not impact disclosure requirements regarding analysis of adviser conflict. Previously, the SEC had suggested that the six-part test adopted by Exchanges should be part of this assessment. These rules are effective for the 2013 proxy season.

Independence Rules Comparison

	The Dodd-Frank Act (DFA)	SEC Rules	NYSE Changes	Nasdaq Changes
Compensation Committee Independence	<ul style="list-style-type: none"> Two factors must be considered <ul style="list-style-type: none"> Additional Compensation Affiliation 	Same as DFA, with no bright-line tests	Same as DFA, with no bright-line tests	Same as DFA, but no outside fees permitted and formal Committee required
Compensation Committee Adviser Retention, Oversight and Funding	<ul style="list-style-type: none"> Sole authority to retain or obtain advice from compensation advisers Directly responsible for the appointment, compensation and oversight of the advisers' work Companies must provide appropriate funding 	Same as DFA	Same as DFA	Same as DFA
Compensation Committee Adviser Independence	<p>Five Factors Must be Considered</p> <ul style="list-style-type: none"> Other services provided by adviser's firm to company Fees received by the adviser's firm from a company as a % of the total revenue of the adviser's firm Policies or procedures maintained by adviser's firm designed to prevent a conflict of interest Business/personal relationship between adviser and Compensation Committee member Company stock owned 	<p>Sixth Factor to be Considered:</p> <ul style="list-style-type: none"> Any business or personal relationships between the executive officers of the company and the compensation adviser or the person employed by the adviser. 	Adopts all six factors	Adopts all six factors
Exemptions	<p><u>All</u>: Controlled companies <u>Compensation Committee Independence only</u>: Limited partnerships, bankrupt companies, open-end management companies, foreign private issuers</p>	<p><u>Additional All</u>: Smaller reporting companies</p>	<p><u>All</u>: Previous exemptions, trusts, derivatives, preferred stock companies, foreign private issuers; limited exemption for smaller reporting companies</p>	<p><u>All</u>: Asset-backed issuers and other passive issuers, cooperatives, limited partnerships, management investment companies, controlled companies, foreign private issuers; limited exemption for smaller reporting companies</p>
Cure	Reasonable opportunity to cure Committee defects	Same as DFA, but leaves procedure to Exchanges	Reasonable opportunity to cure and one-year grace period if majority of Committee is independent	Reasonable opportunity to cure and earlier of next annual meeting or one-year period to cure (but not fewer than 6 months)

Updated Implementation Schedule

Below are the latest updates to our chart tracking the ongoing rulemaking process and likely implementation dates for the multiple compensation-related requirements of Dodd-Frank. Keep in mind that **disclosure rules regarding the assessment of adviser conflict and independence will be in place for the 2013 proxy season**. Final guidance for disclosure of pay-for-performance, the ratio of CEO pay to other employees, hedging, and clawbacks is not expected until well after the November election.

Provision	Effective Dates in DFA	Current Known Status or Scheduled Action
Say on Pay and Say on Frequency	Proxy statements for meetings on or after 1/21/2011	SEC issued Final Rules 1/25/2011 Effective for 2011 proxy season
Say on Golden Parachute	Effective on or after 4/25/2011	SEC issued Final Rules 1/25/2011 Effective for 2011 proxy season
Financial Institution Excessive Compensation Rules	Rules were to have been issued by 4/21/2011	Proposed Rules Issued by Joint Regulators April, 2011 Final Rules “pending” per SEC Likely not effective for 2013 proxy season
Compensation Committee & Adviser Independence; Committee’s Oversight Authority	Rules were to have been effective by 7/16/2011	SEC issued Final Rules June, 2012 Exchanges issued proposed rules Sept., 2012 SEC approved changes January, 2013 <ul style="list-style-type: none"> • Adviser independence & charter: July 1, 2013 • Committee independence: Earlier of (1) the first annual meeting after January 15, 2014, or (2) October 31, 2014
Disclosure of Compensation Consultant Conflict of Interest	Was to have applied to proxy statements for meetings occurring on or after 7/21/2011	SEC issued Final Rules June, 2012 Effective for 2013 proxy season
Clawback Policy	None stated	Final and Proposed Rules “pending” per SEC Likely not effective until 2014
Pay-for-Performance Disclosure	None stated	Final and Proposed Rules “pending” per SEC Likely not effective until 2014
Internal Equity Ratio Disclosure	None stated	Final and Proposed Rules “pending” per SEC Likely not effective until 2014
Disclosure of Hedging	None stated	Final and Proposed Rules “pending” per SEC Likely not effective until 2014
Disclosure of COB/CEO Roles	None stated, but most comply	Effective for 2011 proxy season
Proxy Access	“Universal” rule in July, 2011, but proposals to change bylaws under Rule 14a-8 possible	Rule 14a-8 effective for 2012 proxy season
Broker Non-Vote on Executive Compensation	Effective 7/21/10	SEC to issue clarifying Final Rules TBD Effective for 2011 proxy season

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