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Executive Compensation Hot Topics

November 14, 2012

9:15 a.m. – 10:30 a.m.

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Executive Compensation Hot Topics Roundtable

November 14, 2012

Panelists

- **M. Shan Atkins**
The Pep Boys – Manny Moe & Jack
- **Tonit M. Calaway**
Harley-Davidson Inc. / Harley-Davidson
Foundation, Inc.
- **Curt P. Creely**
Foley & Lardner LLP
- **David A. Hofrichter, Ph.D.**
Aon Hewitt
- **Jessica S. Lochmann Allen**
Foley & Lardner LLP

Pay for Performance

Pay for Performance

- What Does “Pay for Performance” Really Mean in Practice?
 - Measuring pay
 - “Real” or “realizable” pay versus Summary Compensation Table
 - Relative – selection of peers
 - Measuring performance
 - Total shareholder return
 - Financial measures used for incentive compensation
 - Other measures
 - Relative – selection of peers

Pay for Performance

- How should “pay for performance” be presented to shareholders (CD&A)?
 - Use of charts or other graphics
 - Location in proxy statement
 - Establishing workable precedent
 - SEC requirements:
 - GAAP presentation or reconciliation
 - Not materially misleading (balance)
 - Effect of Dodd-Frank required pay for performance disclosure

Say on Pay

Say on Pay – 2012 Proxy Season Results

- Overall results similar to 2011
- The vast majority of companies received majority shareholder support for their “say on pay” votes
- Majority of companies with negative outcomes in 2011 improved in 2012
- There was a correlation between failed “say on pay” votes and negative vote recommendations from proxy advisory services
- Leading factors contributing to failed “say on pay” votes in 2012 included:
 - A perceived disconnect between pay and performance.
 - The presence of disfavored pay practices
- “Say on golden parachute” votes relatively rare

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Say on Pay – Consequences of a Failed Vote

- The consequences of a failed “say on pay” vote include the following:
 - Although all companies will be required to address the “say on pay” vote and any responsive actions in CD&A, this disclosure takes on greater importance for companies with failed “say on pay” votes
 - Proxy advisory services may recommend withholding votes from directors if remedial measures not satisfactory
 - Potential for litigation

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Say on Pay – Litigation

- Despite the disclaimer of new or enhanced fiduciary duties arising from advisory “say on pay” votes, several companies are now facing state law shareholder derivative lawsuits following failed “say on pay” votes
 - More than a dozen companies are facing derivative suits (and in some instances, more than one such suit), and plaintiffs’ class action/derivative firms have announced investigations of additional companies that suffered failed “say on pay” votes
 - The early results have been mixed: some cases have settled, some have been dismissed and one case (Cincinnati Bell) survived an initial motion to dismiss

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Say on Pay – Constituent Engagement

- Company engagement with shareholders on say on pay issues
 - Timing: prior to proxy season
 - Methods:
 - Surveys
 - Group meetings
 - One-on-one meetings
 - Conference calls
 - E-Forums
 - Additional soliciting material
 - Designation of compensation “spokesperson”
- Consider engaging with ISS as well

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Other Dodd-Frank Compensation-Related Provisions

Compensation Committee and Adviser Independence

- Dodd-Frank Act required SEC to issue rules concerning exchange listing standards that would require heightened independence requirements for compensation committee members
- SEC finalized rules in 2012 requiring U.S. stock exchanges to adopt listing standards that: (1) established heightened independence requirements for compensation committee members; (2) required issuers to grant compensation committees the authority to retain, be directly responsible for and pay for compensation advisers; and (3) required compensation committees to assess the independence of any compensation adviser that provides advice to the committee
- Listing standards proposed by NYSE and NASDAQ in September 2012; final listing standards must be adopted by July 27, 2013

Compensation Committee Independence

- NYSE proposed listing standards:
 - In considering independence, must consider all factors specifically relevant to determining whether a director has a relationship to the listed company that is material to that director's ability to be independent from management in connection with the duties of a compensation committee member, including, but not limited to
 - The source of compensation paid to directors serving on the compensation committee; and
 - Whether a director is affiliated with the company, a subsidiary or an affiliate of a subsidiary
- NASDAQ proposed listing standards:
 - Will now require compensation committee composed entirely of independent directors
 - A director will not qualify as independent for service on the compensation committee if he or she has received, directly or indirectly, consulting, advisory or other compensatory fees from the issuer or a subsidiary of the issuer
 - Consider whether the director is affiliated with the company and determine whether such affiliation would impair the director's judgment as a member of the compensation committee

Compensation Committee Responsibilities

- SEC rules required listing standards mandating that compensation committees:
 - Have the authority, in their sole discretion, to retain or obtain the advice of a compensation consultant, independent legal counsel or other adviser;
 - Be directly responsible for the appointment, compensation, and oversight of the work of any compensation adviser they retain; and
 - Receive "appropriate funding" as determined by the compensation committee from the company for payment of reasonable compensation to compensation advisers

Compensation Committee Responsibilities

- NYSE's existing requirement for a written charter setting forth certain specified responsibilities of the committee would be amended to require charter expressly to address the rights and responsibilities of the committee that are required under the SEC rules
- NASDAQ would require a written charter specifying SEC-required rights and responsibilities

Committee Advisor Independence

- SEC rules required the stock exchanges to adopt listing standards stating that a compensation committee "may select" a compensation consultant, legal counsel or other adviser only after taking into account six enumerated independence factors, along with any other factors identified by the stock exchanges
- Six SEC independence factors:
 - Provision of other services to the issuer by the firm that employs the compensation adviser;
 - Amount of fees received from the issuer by the firm that employs the compensation adviser, as a percentage of the total revenue of the firm that employs the compensation adviser;
 - Policies and procedures of the firm that employs the compensation adviser that are designed to prevent conflicts of interest;

Committee Advisor Independence

- Six SEC independence factors (continued):
 - Any business or personal relationship of the compensation adviser with a member of the compensation committee;
 - Any stock of the issuer owned by the compensation adviser or the adviser's immediate family members; and
 - Any business or personal relationship of the compensation adviser or the firm employing the adviser with an executive officer of the issuer.
- NYSE proposed listing standards would also require consideration of all “factors relevant”
- NASDAQ would not require consideration of any additional factors

Clawbacks

- Dodd-Frank Act required the SEC to issue rules directing exchanges to prohibit the listing of issuers that do not develop and implement policies providing:
 - For disclosure of the issuer's policy regarding any incentive-based compensation that is based on financial information required to be reported under the securities laws; and
 - That, if the issuer is required to prepare an accounting restatement due to its material noncompliance with any financial reporting requirement under the securities laws, the issuer will recover from any current or former executive officer who received incentive-based compensation (including stock options awarded as compensation) during the three-year period preceding the date on which the issuer is required to prepare an accounting restatement, based on the erroneous data, in excess of what would have been paid to the executive officer under the accounting restatement

Clawbacks

- Section 304 of the Sarbanes-Oxley Act of 2002 (SOX) already contains a clawback provision, although the standard under the Act is stricter than the SOX standard because SOX requires that the restatement occur “as a result of misconduct,” only applies to a company's CEO and CFO, and is limited to a 12-month period preceding the restatement.
- SEC currently has no publicly-disclosed timetable for these rules

Pay Ratios

- Dodd-Frank requires the SEC to issue rules requiring issuers to disclose in their proxy statements a “pay ratio”:
 - The median of the annual total compensation of all employees of the issuer, except the CEO; the annual total compensation of the CEO; and the ratio of those two amounts, with total compensation determined in accordance with Item 402 of Regulation S-K.
- AFL-CIO proposal to SEC to permit the “median” to be established through statistical sampling has reportedly gained favor with the SEC Staff
- SEC currently has no publicly-disclosed timetable for these rules

Required Pay and Performance Disclosure

- Dodd-Frank requires the SEC to issue rules requiring issuers to disclose “pay for performance” in their proxy statements:
 - Information showing the relationship between executive compensation and the financial performance of the issuer, taking into account any change in the value of the issuer's shares, which may include a graphic representation of the information required to be disclosed.
- SEC currently has no publicly-disclosed timetable for these rules

Institutional Shareholder Services (ISS) Update

- 2013 draft policies released for comment in October
- Comment period closed November 9
- Updates would include:
 - Peer group selection based on 8-digit GICS, with company-selected peers as an input
 - Pledging of shares possible “deal-killer” (medium concern under 2012 policies)
 - Realizable pay as supplemental tool (not used under 2012 policies)
 - Board responsiveness required after one year of majority of votes cast (rather than two years under 2012 policies)
 - Say on golden parachute evaluation considers legacy provisions (ignored under 2012 policies)
 - ESG performance goals case by case (rather than generally “against” in 2012)

NYSE Releases Proposed Listing Standards Applicable to Compensation Committees

Legal News Alert: Transactional & Securities
October 3, 2012

Overview

On September 25, 2012,¹ the NYSE released a proposal (Proposal), subject to approval by the SEC, regarding independence requirements for compensation committees of NYSE-listed companies (NYSE Compensation Committees) based on the final rules that the SEC adopted June 20, 2012 (SEC Rules).² The SEC Rules require the NYSE, as well as other national securities exchanges, to adopt listing standards on three topics: (i) the independence of NYSE Compensation Committee members (Members); (ii) an NYSE Compensation Committee's authority to retain its own compensation advisers; and (iii) consideration by an NYSE Compensation Committee of specified factors that could bear on the independence of compensation advisers.

The Proposal does not break any significant new ground. As discussed below, the NYSE is not proposing to add any new specific test that a Member must meet to qualify as independent for NYSE Compensation Committee purposes. Likewise, the NYSE rules relating to compensation adviser retention remain effectively unchanged. Finally, as the SEC Rules require, the Proposal would add a new requirement for an NYSE Compensation Committee to consider specified factors as they relate to compensation advisers; the Proposal mirrors the six factors in the SEC Rules but also provides that the NYSE Compensation Committee must consider "all factors relevant to that person's independence from management."

Importantly, as to a Member's independence for NYSE Compensation Committee purposes, the Proposal does not contain any numerical tests or absolute prohibitions. In addition, the Proposal specifically provides that share ownership alone, no matter the percentage, would not require an affirmative finding that a Member is not independent.

Highlights of the Proposed NYSE Listing Standards

INDEPENDENCE OF NYSE COMPENSATION COMMITTEE MEMBERS

SEC Rules. The SEC Rules direct national securities exchanges to adopt listing standards that require each Member to be "independent" and to define the term "independent" in its standards.

NYSE Proposed Standards. The Proposal does not make any significant changes to the NYSE's existing independence standards applicable to Members. The Proposal adds certain consideration requirements applicable to a board of directors (Board) of an NYSE-listed company (NYSE Company), but the NYSE did not propose a more stringent independence test like the one that applies to members of audit committees.



The NYSE Listed Company Manual (NYSE Manual) already requires Members to be independent. Specifically, the NYSE Manual currently provides that a Member does not qualify as “independent” unless a Board affirmatively determines that the Member has no material relationship with the NYSE Company. This subsection sets forth five “bright-line” tests to be used in making this determination, and the Proposal would not change any of these tests.

The Proposal would add subsection 303A.02(a)(ii) to the NYSE Manual, which would require that, in affirmatively determining the independence of any Member for NYSE Compensation Committee purposes, the Board must consider “all factors specifically relevant” to determining whether such Member has a relationship to the NYSE Company that is material to the Member’s ability to be independent from management in connection with the Member’s NYSE Compensation Committee duties, including but not limited to the following two factors cited in the SEC Rules:

- » The source of compensation of a director, including any consulting, advisory, or other compensatory fee paid by the NYSE Company to such member of the Board
- » Whether a director is affiliated with the NYSE Company, a subsidiary of the NYSE Company, or an affiliate of a subsidiary of the NYSE Company

The Proposal also makes clear that the NYSE will not dictate any specific numerical tests with respect to the factors in the proposed rule. In particular, a Board need not make an affirmative finding that a Member is not independent based solely on the fact that the Member (and/or the Member’s affiliates) hold in excess of a specific percentage of the NYSE Company’s outstanding shares. The NYSE re-affirmed its position that share ownership in an NYSE Company aligns the Member’s interests with those of its shareholders. Furthermore, the NYSE believes that the NYSE’s existing “bright-line” independence rules are sufficiently broad to encompass all forms of relationships that would negate a Member’s independence regarding the Member’s NYSE Compensation Committee duties.

However, the Proposal would, in commentary to the new rules, provide that when considering the sources of a Member’s compensation in this context, the Board should consider whether the Member receives compensation from any other source, including sources outside of the NYSE Company, that would impair the Member’s ability to make independent judgments about the NYSE Company’s compensation. The commentary also would state that the Board should consider whether an affiliate relationship places the Member under the direct or indirect control of the NYSE Company or its senior management, or creates a direct relationship between the Member and members of senior management, in each case of a nature that would impair the Member’s ability to make independent judgments about the NYSE Company’s compensation.

NYSE COMPENSATION COMMITTEE AUTHORITY TO RETAIN ADVISERS

SEC Rules. Under the SEC Rules, listing standards must require that (i) a compensation committee has the authority to retain its own compensation advisers, (ii) the compensation committee is directly responsible for the appointment, compensation, and oversight of each adviser that it retains, and (iii) a company provide appropriate funding to its compensation committee to allow the committee to pay reasonable compensation to advisers. The listing standards need not, however, require a compensation committee to retain its own advisers.

Proposed Standards. The existing NYSE listing standards already substantially incorporate these SEC Rule provisions (in subsection 303A.05(b)). Nevertheless, largely for the sake of clarity, the NYSE has proposed to adopt the SEC Rule provisions verbatim as proposed new subsection 303A.05(c). Subsection 303A.05(b), in turn, would be revised to state that the NYSE Compensation Committee charter must provide for the specified powers.



NYSE COMPENSATION COMMITTEE REVIEW OF FACTORS IMPACTING COMPENSATION ADVISER INDEPENDENCE

SEC Rules. The SEC Rules direct national securities exchanges to adopt listing standards that require a compensation committee to take into consideration specified factors that could bear on the independence of any compensation consultant, legal counsel, or other advisers (Compensation Advisers) to the committee, including Compensation Advisers that the compensation committee retains or that management retains (but excluding in-house legal counsel).

Proposed Standards. The NYSE proposes to adopt essentially verbatim the list of six factors set forth in the SEC Rules and not add any additional specific factors. While not adding any additional specific factors, however, subsection 303A.05(c), as proposed, would be broader in scope than what the SEC Rules require because it would compel an NYSE Compensation Committee to consider all factors relevant to that Compensation Adviser's independence from management prior to selecting the Compensation Adviser as an adviser to the committee. Specifically, the NYSE Compensation Committee must consider the following six factors when making this selection:

- » The provision of other services to the NYSE Company by the employer of the Compensation Adviser (Advisory Employer)
- » The amount of fees received from the NYSE Company by the Advisory Employer as a percentage of the total revenue of the Advisory Employer
- » The Advisory Employer's policies and procedures designed to prevent conflicts of interest
- » Business or personal relationships of the Compensation Adviser with Members
- » Business or personal relationships of the Advisory Employer or the Compensation Adviser with executive officers of the NYSE Company
- » Any stock in the NYSE Company owned by the Compensation Adviser

The Proposal requires that the NYSE Compensation Committee undertake this analysis prior to selecting any Compensation Adviser. The Proposal does not expand upon the requirement to consider all relevant factors in commentary to the rule or elsewhere in the Proposal. The broad language arguably makes it more difficult for an NYSE Compensation Committee to satisfy the requirement than would have been the case if the committee could simply have focused on the six factors. However, the NYSE's director independence rules have long required the Board to consider all factors impacting director independence, and as noted above, the Proposal uses similar language in describing the requirement that applies to Member independence.

The Proposal does not specifically address many questions relating to the new requirement and the six factors, which include the following:

- » How often must the NYSE Compensation Committee consider the factors as to any given Compensation Adviser?
- » Where a Compensation Adviser works with others in an Advisory Employer, as to which employees of the Advisory Employer must the NYSE Compensation Committee consider the factors?
- » As to what period must the NYSE Compensation Committee consider fees?
- » What relationships are relevant? And how can an Advisory Employer have personal relationships with individuals?
- » How should stock ownership be calculated for the final factor?



The factors listed above are required considerations, but there will be no requirement that an NYSE Compensation Committee only use Compensation Advisers that are independent so long as the NYSE Compensation Committee undertakes such analysis for each Compensation Adviser. Consistent with the SEC Rules, the Proposal would not require that an NYSE Compensation Committee engage in such analysis with respect to in-house legal counsel, as the committee is on notice that in-house legal counsel are not disinterested.

The Proposal also would include, consistent with the SEC Rules, an express statement to the effect that an NYSE Compensation Committee is not required to implement or act consistently with the advice or recommendations of retained advisers and that factors to be considered by the NYSE Compensation Committee do not affect the ability or obligation of the NYSE Compensation Committee to exercise its own judgment in the fulfillment of its duties.

In response to comments, the NYSE expressly considered, but did not propose, a disclosure requirement relating to Compensation Advisers. The relevant commenter also had proposed requiring, with respect to outside counsel that the NYSE Compensation Committee hired, the same disclosure that SEC rules require with respect to the nature of any conflict that arises from the engagement of a compensation consultant. The NYSE did not believe that it was necessary to establish additional disclosure requirements. With respect to disclosure of any conflicts of interest that may arise with respect to outside counsel that the committee hired, the NYSE stated its belief that the rigorous conflict of interest requirements applicable to attorneys adequately address the commenter's concerns.

CURE PERIODS

SEC Rules. The SEC Rules require exchange rules to include appropriate procedures for listed issuers to have a reasonable opportunity to cure any non-compliance with the new listing standards. Specifically, if a Member ceases to be independent in accordance with the new requirements for reasons outside the Member's reasonable control, then the Member, with notice by the issuer to the exchange, may remain a Member until the earlier of the next annual meeting or one year from the occurrence of the event that caused the Member to be no longer independent.

Proposed Standards. The NYSE proposes to adopt the SEC Rule cure provision (as part of Section 303A.00). Importantly, the Proposal would limit the use of this cure provision to circumstances where the NYSE Compensation Committee would continue to have a majority of independent directors (excluding the Member who is determined to be no longer independent).

TIMING

The NYSE proposes to have the new listing standards effective July 1, 2013, but NYSE Companies would have until the earlier of (i) their first annual meeting held after January 15, 2014 or (ii) October 31, 2014, to comply with the new director independence standards for NYSE Compensation Committees contained in subsection 303A.02(a)(ii).

EXEMPTIONS

The Proposal provides an exemption for all categories of issuers that are currently exempt from the NYSE's existing NYSE Compensation Committee requirements, including controlled companies, limited partnerships and companies in bankruptcy, closed-end and open-end funds registered under the 1940 Act, passive business organizations in the form of trusts (such as royalty trusts), derivatives and special purpose securities (as described in Sections 703.19 and 703.20 of the NYSE Manual), and issuers whose only listed equity security is a preferred stock.

Smaller reporting companies are not required to comply with the proposed NYSE rules regarding Member independence standards or Compensation Adviser independence considerations, but must comply with all other proposed NYSE rules regarding the authority and responsibilities of NYSE Compensation Committees.



Actions NYSE Companies Should Take Now

NYSE Companies should begin taking steps now to ensure that they will be able to comply with the new listing standards promptly, assuming that they are approved by the SEC, including the following:

- 1. Review current NYSE Compensation Committee membership in light of the proposed membership standards.** NYSE Companies should pay special attention to the sources of compensation of Members, including any consulting, advisory, or other compensatory fees paid by the NYSE Company or any other source to any Member. An NYSE Company also should focus on whether a Member is affiliated with the NYSE Company, a subsidiary of the NYSE Company, or an affiliate of a subsidiary of the NYSE Company. In addition to these two factors, the Board must consider all factors relevant to each Member's independence. A Board has broad discretion to determine how the specified factors and any other relevant factors may affect a Member's independence, but it should be able to show that the specified factors and any other relevant factors were carefully considered. In particular, a Board should be able to justify why fees or affiliations would not disqualify a Member from being independent.
- 2. Review current arrangements with Compensation Advisers for problematic facts.** An NYSE Compensation Committee should explore whether consideration of all relevant factors as to each of its current Compensation Advisers might present problematic facts and ensure that engagement of future Compensation Advisers includes consideration of all relevant factors, including each of the factors set forth in the Proposal.

An NYSE Company or its NYSE Compensation Committee should obtain from Compensation Advisers adequate information to enable the NYSE Company or NYSE Compensation Committee to consider all relevant factors, including the enumerated factors. The NYSE Company or NYSE Compensation Committee may then consider whether there is information as to any Compensation Adviser that the committee did not already know that is likely to trouble the NYSE Compensation Committee, keeping in mind that there is no requirement that an NYSE Compensation Committee only use Compensation Advisers that are in fact independent in the sense that they do not present questions under any of the factors. If the NYSE Company, rather than its NYSE Compensation Committee, is generally involved in this preliminary work, then the NYSE Company should nonetheless advise the NYSE Compensation Committee of the new rules and perhaps seek preliminary feedback. Of course, if the preliminary work raises valid concerns, then the NYSE Company and its NYSE Compensation Committee will need to consider what actions to take to address the situation.

- 3. Review current NYSE Compensation Committee charter regarding committee authority to retain advisers.** The Proposal does not significantly alter the NYSE's current listing standards with regard to this subject matter, but an NYSE Company should confirm that its NYSE Compensation Committee charter expressly provides that (i) the NYSE Compensation Committee has the authority to retain its own compensation advisers, (ii) the NYSE Compensation Committee is directly responsible for the appointment, compensation, and oversight of each adviser that it retains, and (iii) the NYSE Company must provide appropriate funding to the NYSE Compensation Committee.
- 4. Review engagement arrangements with Compensation Advisers that the Committee has retained.** Furthermore, given that an NYSE Company's Compensation Committee is directly responsible for the appointment, compensation, and oversight of the work of any Compensation Advisers that the NYSE Compensation Committee retains, the NYSE Company should review the relationships with any Compensation Advisers that the NYSE Compensation Committee retains to ensure the proper level of committee involvement.



¹ The Proposal was amended on October 1, 2012 solely with regard Exhibit 5, Section 303A.00 under the heading, "Transition Periods for Compensation Committee Requirements."

² The SEC Rules regarding Compensation Committees are discussed in more detail in Foley & Lardner LLP's [Legal News Alert on this topic dated June 25, 2012](#). The SEC Rules were adopted in response to the mandate of Section 952 of the Dodd-Frank Wall Street Reform and Consumer Protection Act.

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NASDAQ Releases Proposed Listing Standards Applicable to Compensation Committees

Legal News Alert: Transactional & Securities
October 8, 2012

Overview

On September 25, 2012, the NASDAQ Stock Market (Nasdaq) released a proposal (Proposal), subject to approval by the SEC, regarding independence requirements for compensation committees of Nasdaq-listed companies (Nasdaq Compensation Committees) based on the final rules that the SEC adopted June 20, 2012 (SEC Rules).¹ The SEC Rules require Nasdaq, as well as other national securities exchanges, to adopt listing standards on three topics: (i) the independence of Compensation Committee members (Members); (ii) a Compensation Committee's authority to retain its own compensation advisers; and (iii) consideration by a Compensation Committee of specified factors that could bear on the independence of compensation advisers.

Unlike the changes that the NYSE proposed,² which largely follow the standards and requirements outlined in the SEC Rules, the changes that Nasdaq proposed go above and beyond the SEC Rules. Nasdaq's proposed rules would, among other things: require Nasdaq-listed companies (Nasdaq Companies) to have compensation committees (as the NYSE listing standards already require); raise the independence standards for Members, in some cases applying the heightened independence standards established for audit committees; and require Nasdaq Compensation Committees to have charters establishing specified rules and standards (as the NYSE listing standards also already require). In contrast, with regard to standards for Nasdaq Compensation Committee advisers, Nasdaq proposes to adopt the standards set forth in the SEC Rules and does not propose to materially change or add to these standards.

Highlights of the Proposed Nasdaq Listing Standards

COMPENSATION COMMITTEE REQUIREMENT

Although not required to do so under the SEC Rules, the Proposal would require Nasdaq Companies, including smaller reporting companies, to have a compensation committee consisting of at least two members of the Nasdaq Company's board of directors (Board), each of whom must be an "Independent Director" as defined in the Nasdaq Listed Company Rules (Nasdaq Rules). The Proposal would effect this requirement by eliminating the ability of a Nasdaq Company to have Independent Directors vote to approve compensation as members of the Board rather than acting as a committee.

INDEPENDENCE OF NASDAQ COMPENSATION COMMITTEE MEMBERS

SEC Rules. The SEC Rules direct national securities exchanges to adopt listing standards that require each Member to be "independent" and to define the term "independent" in its standards. The standards are required to be more



stringent than the test that applies to directors generally (but do not need to be as stringent as the test that applies to audit committee members) and must take into account the following factors:

- » The sources of compensation of Members, including any consulting, advisory, or other compensatory fee paid by the Company to any Member
- » Whether a director is affiliated with the Company, a subsidiary of the Company, or an affiliate of a subsidiary of the Company

Nasdaq Proposed Standards. Under Nasdaq’s current listing standards, a Board is required to make an affirmative determination that an Independent Director does not have any relationship that, in the opinion of the Board, “would interfere with the exercise of independent judgment in carrying out the responsibilities of a director.” Presumably, for a director who will serve as a Member, the Board would need to take into account responsibilities in his or her role on the Nasdaq Compensation Committee. The Nasdaq Rules currently specify certain categories of directors that cannot qualify as Independent Directors, which categories would not change under the Proposal. Under the Proposal, however, Nasdaq will adopt additional independence standards applicable to Members based on the sources of compensation and affiliated-status factors that the SEC Rules enumerate.

With regard to sources of director compensation, Nasdaq proposes to apply to Members the same standard that currently applies to audit committee members under the SEC’s Rule 10A-3 (which rule is incorporated into Nasdaq Rule 5605(c)(2)(A)(ii)) and, thus, would prohibit Members from accepting, directly or indirectly, any consulting, advisory, or other compensatory fees (other than solely for Board service and certain retirement amounts) from the Nasdaq Company or any subsidiary of the Nasdaq Company. Also similar to the SEC’s Rule 10A-3, the prohibition on a Member’s receipt of fees would not include a “look-back” period; rather, the prohibition would apply as of the commencement of the Member’s service on the Nasdaq Compensation Committee. This prohibition is in contrast to the current Nasdaq Rules, which allow an Independent Director (including a director serving as a Member) to receive a limited amount of compensation from the Nasdaq Company and its subsidiaries.

Regarding the affiliated-status factor, the Proposal basically mirrors the SEC Rule and requires a Board to consider a Member’s affiliations with the Nasdaq Company and its subsidiaries and other affiliates in making an independence determination regarding such Member, although Nasdaq does not propose to adopt any “bright-line” tests regarding this factor. In particular, a Board need not make an affirmative finding that a Member is not independent based solely on the fact that the Member (and/or the Member’s affiliates) holds in excess of a specific percentage of the Nasdaq Company’s outstanding shares. Nasdaq considered whether to apply the same standards to Members as it currently applies to audit committee members, which standards prohibit affiliates from being audit committee members and include as affiliates persons having beneficial ownership of more than 10 percent of any class of voting shares of the Nasdaq Company. Nasdaq re-affirmed its position that share ownership in a Nasdaq Company aligns the Member’s interests with those of the Nasdaq Company’s shareholders and, thus, that it may be appropriate for such persons to serve as Members. No look-back period would apply under the Proposal with regard to the affiliated-status factor; hence, a Board would only be required to consider a Member’s affiliations that exist at and after the start of his or her service as a Member.

Nasdaq deems these standards to be sufficient to ensure a Member’s independence and, therefore, does not propose to adopt any additional factors. The Proposal also provides that Nasdaq would maintain its existing exception allowing certain non-independent directors to serve on a Nasdaq Compensation Committee under exceptional and limited circumstances.³ Furthermore, if a Nasdaq Company were to fail to comply in certain circumstances with the proposed



Compensation Committee requirements, it may rely on the existing cure-period provision in the Nasdaq Rules, which provision would remain unchanged and be applicable to the new Nasdaq Rules under the Proposal.⁴

COMPENSATION COMMITTEE CHARTER AND AUTHORITY TO RETAIN ADVISERS

SEC Rules. Under SEC Rules 10C-1(b)(2) and (3), listing standards must require that (i) a Compensation Committee has the authority to retain its own compensation advisers, (ii) the Compensation Committee is directly responsible for the appointment, compensation, and oversight of each adviser that it retains, and (iii) the Company provide appropriate funding to the Compensation Committee to allow the committee to pay reasonable compensation to its advisers. The listing standards need not require, however, a committee to retain its own advisers.

Nasdaq Proposed Standards. Although not required by the SEC Rules, the Proposal would require each Nasdaq Company to adopt a formal, written Compensation Committee charter (Charter). A Charter would be required to specify the following:

- » The scope of the Nasdaq Compensation Committee's responsibilities and how it carries out those responsibilities, including structure, processes, and membership requirements
- » The Nasdaq Compensation Committee's responsibility for determining, or recommending to the Board for determination, the compensation of the chief executive officer and all other executive officers of the Nasdaq Company
- » That the chief executive officer of the Nasdaq Company may not be present during voting or deliberations by the Nasdaq Compensation Committee on his or her compensation
- » That a Nasdaq Compensation Committee must have the specific Compensation Committee responsibilities and authority necessary to comply with SEC rules relating to: (i) the authority to retain compensation consultants, independent legal counsel, and other compensation advisers; (ii) the authority to fund such advisers; and (iii) the responsibility to consider certain independence factors before selecting such advisers, other than in-house legal counsel

The first three Charter requirements are based on current Nasdaq Rules applicable to Compensation Committees (or committees currently performing functions typically performed by Compensation Committees) and, therefore, should not require any new action on the part of a Nasdaq Company's Board or Compensation Committee (unless, of course, the Compensation Committee is newly formed).⁵ The final Charter requirement is modeled after Nasdaq Rule 5605(c)(1)(D) related to audit committee charters and, thus, would introduce new authority requirements and responsibilities for Nasdaq Compensation Committees. Compliance with the final Charter requirement also would require action on the part of a Board to ensure that the Charter explicitly provides the Compensation Committee with such authority and responsibilities.

COMPENSATION COMMITTEE REVIEW OF FACTORS IMPACTING COMPENSATION ADVISER INDEPENDENCE

SEC Rules. SEC Rule 10C-1(b)(4) directs national securities exchanges to adopt listing standards that require a Compensation Committee to take into consideration specified factors that could bear on the independence of any compensation consultant, legal counsel, or other adviser (Compensation Advisers) to the Compensation Committee, including Compensation Advisers that the Committee retains or that management retains (but excluding in-house legal counsel).



Nasdaq Proposed Standards. Nasdaq proposes to adopt exclusively the list of six factors set forth in the SEC Rules and does not propose to add any specific additional factors. The Proposal does not, in fact, specify the six factors; rather, Nasdaq Rule 5605(d)(3), as proposed, would require a Nasdaq Company to give its Nasdaq Compensation Committee the responsibility to consider the factors enumerated in the SEC Rules before selecting Compensation Advisers. Those factors are as follows:

- » The provision of other services to the Nasdaq Company by the employer of the Compensation Adviser (Advisory Employer)
- » The amount of fees received from the Nasdaq Company by the Advisory Employer as a percentage of the total revenue of the Advisory Employer
- » The Advisory Employer's policies and procedures designed to prevent conflicts of interest
- » Business or personal relationships of the Compensation Adviser with Members
- » Business or personal relationships of the Advisory Employer or the Compensation Adviser with executive officers
- » Any stock in the Nasdaq Company owned by the Compensation Adviser

The Proposal makes clear that, consistent with SEC Rule 10C-1(b)(2)(iii), Nasdaq Compensation Committees would not be required to implement or act consistently with the advice or recommendations of retained Compensation Advisers. Moreover, factors to be considered by the Nasdaq Compensation Committee would not affect the ability or obligation of the Nasdaq Compensation Committee to exercise its own judgment in the fulfillment of its duties. Further, the Proposal states, "Like the Commission, Nasdaq seeks to emphasize that a compensation committee is not required to retain an independent compensation adviser; rather, a compensation committee is required only to conduct the independence analysis described in Rule 10C-1 before selecting a compensation adviser."

The Proposal does not specifically address many questions relating to the new requirement and the six factors, which include the following:

- » How often must the Nasdaq Compensation Committee consider the factors as to any given Compensation Adviser?
- » Where a Compensation Adviser works with others in an Advisory Employer, as to which employees of the Advisory Employer must the Nasdaq Compensation Committee consider the factors?
- » As to what period must the Nasdaq Compensation Committee consider fees?
- » What relationships are relevant? And how can an Advisory Employer have personal relationships with individuals?
- » How should stock ownership be calculated for the final factor?

TIMING

Nasdaq proposes that the new listing standards become effective upon SEC approval, but Nasdaq Companies would have until the earlier of (i) their second annual meeting of shareholders held after the date of SEC approval of the Proposal or (ii) December 31, 2014 to comply with all but one of the proposed new rules. Nasdaq Companies would be required to comply with proposed Nasdaq Rule 5605(d)(3) regarding a Nasdaq Compensation Committee's authority to retain and fund Compensation Advisers, and its responsibility to consider the six factors enumerated in the SEC Rules before selecting a Compensation Adviser, immediately upon SEC approval of the new listing standards. For the relatively few Nasdaq Companies that do not currently have a formal Nasdaq Compensation Committee, the provisions



of proposed Nasdaq Rule 5605(d)(3) would apply to the independent directors that perform the same functions pertaining to compensation until such time as a Compensation Committee is established. Nasdaq Companies will be required to certify to Nasdaq that they have complied with the new listing requirements regarding Compensation Committees (including those requirements under proposed Nasdaq Rule 5605(d)(3) that would become effective immediately upon approval by the SEC) within 30 days after the applicable compliance dates. Thus, a Nasdaq Company would have to act in advance of SEC approval of the Proposal (or very quickly thereafter) to be able to make a certification regarding compliance with Nasdaq Rule 5605(d)(3) on a timely basis.

Under the Proposal, Nasdaq's existing phase-in schedules for compensation-related listing rules, applicable to Nasdaq Companies listing in connection with an initial public offering, Nasdaq Companies emerging from bankruptcy, and Nasdaq Companies ceasing to be controlled companies, would remain generally unchanged. The Proposal clarifies that such Nasdaq Companies could phase in compliance with the minimum Compensation Committee size requirement and additional Member eligibility requirements, as described above.

EXEMPTIONS

The Proposal provides an exemption for all categories of issuers that are currently exempt from Nasdaq's existing Compensation Committee requirements, including asset-backed issuers and other passive issuers, cooperatives, limited partnerships, management investment companies, and controlled companies, as well as foreign private issuers that provide the disclosures already required in the Nasdaq Rules.

Smaller reporting companies, which are currently exempt under the SEC Rules, would not be required to adhere to the proposed higher independence standards for Members or to consider the six factors enumerated in the SEC Rules before selecting Compensation Advisers (although smaller reporting companies would be required to have Compensation Committees and Charters).

Actions Companies Should Take Now

Nasdaq Companies should begin taking steps now to ensure that they will be able to comply with the new listing standards promptly, assuming that they are approved by the SEC, including the following:

- 1. Establish a Compensation Committee.** If a Nasdaq Company does not already have a Compensation Committee, the Nasdaq Company should begin forming this committee. In light of the heightened Compensation Committee requirements, a Board will require sufficient time to establish a Compensation Committee that meets the existing and new standards, especially those regarding the independence of potential Members.
- 2. Review current Compensation Committee membership in light of the proposed membership standards.** Nasdaq Companies should pay special attention to the proposed heightened standard prohibiting Members from receiving any consulting, advisory, or other compensatory fees (other than solely for Board service and certain retirement amounts) paid by the Nasdaq Company or any of its subsidiaries.

A Nasdaq Company also should focus on whether a director is affiliated with the Nasdaq Company, a subsidiary of the Nasdaq Company, or an affiliate of a subsidiary of the Nasdaq Company. A Board has broad discretion to determine how this factor may affect a director's independence, but it should be able to show that this factor was carefully considered and justify why certain affiliations would not disqualify a Member from being independent.

- 3. Review current arrangements with Compensation Advisers for problematic facts.** Nasdaq Companies should review arrangements with current Compensation Advisers and carefully consider each of the six factors cited in the SEC



Rules and incorporated into the Proposal. Nasdaq Companies should keep in mind that this rule becomes effective immediately upon SEC approval and that the Nasdaq Company will need to certify as to compliance within 30 days thereafter.

A Nasdaq Company or its Nasdaq Compensation Committee should obtain from Compensation Advisers adequate information to enable the Nasdaq Company or Nasdaq Compensation Committee to consider the enumerated factors. The Nasdaq Company or Nasdaq Compensation Committee may then consider whether there is information as to any Compensation Adviser that the committee did not already know that is likely to trouble the Nasdaq Compensation Committee, keeping in mind that there is no requirement that a Nasdaq Compensation Committee only use Compensation Advisers that are in fact independent in the sense that they do not present questions under any of the factors. If the Nasdaq Company, rather than its Nasdaq Compensation Committee, is generally involved in this preliminary work, then the Nasdaq Company should nonetheless advise the Nasdaq Compensation Committee of the new rules and perhaps seek preliminary feedback. Of course, if the preliminary work raises valid concerns, then the Nasdaq Company and its Nasdaq Compensation Committee will need to consider what actions to take to address the situation.

- 4. Prepare or review the company's Compensation Committee Charter.** The Proposal expressly lays out the required elements of a Charter. If a Nasdaq Company does not currently have a Charter, or if the Charter does not include all of the Proposal's requirements, the Nasdaq Company should prepare or amend its Charter accordingly, including formal adoption or amendment by the Board. Once the Charter is in effect, the Board should be able to show that it has complied with the terms of its Charter in connection with the evaluation and selection of each Member. A Nasdaq Company must review and reassess its Charter on an annual basis.

While a Nasdaq Company has until one of the two dates noted above under the caption "Timing" to adopt a Charter with the elements specified in the Proposal, a Nasdaq Company must comply with Nasdaq Rule 5605(d)(3) immediately upon approval of the Proposal by the SEC. The company will have 30 days thereafter, however, to certify as to such compliance, as described above. Thus, by the time of SEC approval of the Proposal (or, in any event, no later than 30 days thereafter, when the required certification is due), a Nasdaq Company must make sure that its Compensation Committee has, through effective Board action, the authority to retain and fund Compensation Advisers and the responsibility to consider the six factors discussed above as to Compensation Advisers. Under the Proposal, Nasdaq states, "Companies should consider under state corporate law whether to grant these specific responsibilities and authority through a charter, resolution or other board action; however, Nasdaq proposes to require only that compensation committees immediately have such responsibilities and authority."

- 5. Review engagement arrangements with Compensation Advisers that the Committee has retained.** Given that a Nasdaq Company's Compensation Committee is directly responsible for the appointment, compensation, and oversight of the work of any Compensation Advisers that the Nasdaq Compensation Committee retains, the Nasdaq Company should review the relevant relationships with any Compensation Advisers that the Nasdaq Compensation Committee retains to ensure the proper level of committee involvement.

¹ The SEC Rules regarding Compensation Committees are discussed in more detail in Foley's *Legal News Alert* on this topic, dated June 25, 2012. [<http://www.foley.com/sec-releases-final-rules-regarding-compensation-committees-compensation-consultants-and-other-advisers-06-25-2012/>]

² The proposed NYSE Rules regarding Compensation Committees are discussed in more detail in Foley's *Legal News Alert* on this topic, dated October 3, 2012. [<http://www.foley.com/nyse-releases-proposed-listing-standards-applicable-to-compensation-committees-10-03-2012/>]

³ Nasdaq Rule 5605(d)(3): "If a Compensation Committee has at least three members, one director who is not independent and not an executive officer, employee or family member of an executive officer, may be appointed as a Member if the Board, under exceptional and limited



circumstances, determines that such individual's membership on the committee is required by the best interests of the company and its shareholders."

⁴ Nasdaq Rule 5605(b)(1)(A) sets forth the applicable cure provision, "If a Company fails to comply with this requirement due to one vacancy, or one director ceases to be independent due to circumstances beyond their reasonable control, the Company shall regain compliance with the requirement by the earlier of its next annual shareholders meeting or one year from the occurrence of the event that caused the failure to comply with this requirement; provided, however, that if the annual shareholders meeting occurs no later than 180 days following the event that caused the failure to comply with this requirement, the Company shall instead have 180 days from such event to regain compliance. A Company relying on this provision shall provide notice to Nasdaq immediately upon learning of the event or circumstance that caused the noncompliance."

⁵ These requirements are based on Nasdaq Rules 5605(c)(1)(A), 5605(d)(1) and (2), and 5605(d)(1), respectively.

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