Chapter 5

Compensation Committee

[Chapter 5 is current as of September 1, 2010.]

SUMM 5:1  Overview
SUMM 5:2  Dodd-Frank Act Compensation Committee Requirements
SUMM 5:3  NYSE Compensation Committee Requirements
SUMM 5:4  Nasdaq Rules Relating to Executive Compensation
SUMM 5:5  SEC Corporate Governance Disclosure Relating to Compensation Committees
SUMM 5:6  Additional Compensation Committee Independence Considerations
SUMM 5:7  Proposed Legislation to Heighten Independence Standards

§ 5:1  Dodd-Frank Act Compensation Committee Requirements
  § 5:1.1  Overview
  § 5:1.2  Relevant Text of the Dodd-Frank Act
  § 5:1.3  Discussion of the Requirements
        [A]  Compensation Committee Independence
        [B]  Additional Disclosure Under the Dodd-Frank Act
        [B][1]  Background
        [B][2]  Discussion of the Additional Disclosure Under the Dodd-Frank Act

§ 5:2  NYSE Compensation Committee Requirements
  § 5:2.1  Overview
  § 5:2.2  Text of Section 303A.05 (Including NYSE Commentary)
  § 5:2.3  Discussion of the Rule
  § 5:2.4  Sample Compensation Committee Charter for NYSE-Listed U.S. Companies

§ 5:3  Nasdaq Rules Relating to Executive Compensation
  § 5:3.1  Overview
  § 5:3.2  Text of Rule 5605(d) (Including Interpretations)
  § 5:3.3  Discussion of the Rule
  § 5:3.4  Sample Compensation Committee Charter for Nasdaq-Listed U.S. Companies
SUMM 5:1  PUBLIC COMPANY DESKBOOK

§ 5:4  SEC Corporate Governance Disclosure Relating to Compensation Committees
   § 5:4.1  Background
   § 5:4.2  Text of SEC Rules Relating to Compensation Committees
      [A] Item 407(e) of Regulation S-K
      [B] Items 7 and 8 of Schedule 14A
   § 5:4.3  Compensation Committee Process
      [A] Requirements Under 2006 Rule
      [B] Compensation Consultant Disclosure Under 2009 Revisions
      [B][1] Background
      [B][2] Discussion of 2009 Revisions

§ 5:5  Additional Compensation Committee Independence Considerations
   § 5:5.1  Background
   § 5:5.2  Standards for Outside Director Under Section 162(m) of the Code
      [A] Text of Requirements
      [A][1] Section 162(m) of the Internal Revenue Code
      [A][2] Treasury Regulation 1.162-27(e)(3)
      [B] Discussion of the Rule
      [B][1] Requirements to Be an Outside Director
      [B][2] Former Officer
      [B][3] Remuneration Received from the Company
   § 5:5.3  Standards for Non-Employee Director Under Section 16 of the Exchange Act
      [A] Text of Requirements
      [A][1] Text of Section 16(b) of the Exchange Act
      [A][2] Text of Rule 16b-3
      [B] Discussion of the Rule

§ 5:6  Proposed Legislation to Heighten Independence Standards

SUMM 5:1  Overview
   In 2003, the NYSE and Nasdaq Stock Market, as part of their adoption of heightened corporate governance standards, adopted rules that required boards of directors to establish compensation committees composed entirely of independent directors that have broad responsibility for executive and director compensation. In 2006, the SEC issued comprehensive changes to its executive compensation rules, which included a consolidation and expansion of the required disclosure relating to corporate governance practices. In addition, public company directors serving on the compensation committee have long been subject to the independence standards effectively imposed by section 16 of the Exchange Act and section 162(m) of the Internal Revenue Code.
SUMM 5:2  Dodd-Frank Act Compensation Committee Requirements

On July 21, 2010, President Obama signed into law the Dodd-Frank Wall Street Reform and Consumer Protection Act (the “Dodd-Frank Act”), which included revisions to the independence requirements for compensation committees. In particular, section 952 adds a new section 10C to the Exchange Act, which requires the SEC to promulgate rules requiring national securities exchanges to prohibit the listing of an issuer’s equity securities if its board does not have an independent compensation committee.

SUMM 5:3  NYSE Compensation Committee Requirements

Under the NYSE listing standards, each U.S. listed company must have a compensation committee composed of independent directors.

The compensation committee must have a written charter, which must be posted on the company’s website, addressing (at a minimum) the committee’s purpose and responsibilities, including determining (either as a committee or together with the other independent directors) the compensation of the CEO, exercising authority or making recommendations to the board with respect to non-CEO executive officer compensation, and producing the annual report on executive compensation.

The rules expressly permit the responsibilities of the compensation committee to be allocated to one or more other committees composed entirely of independent directors.

SUMM 5:4  Nasdaq Rules Relating to Executive Compensation

Under the Nasdaq listing standards, the compensation of the CEO and officers of each listed company (other than controlled companies) must be determined, or recommended to the board for determination, by either a majority of the independent directors or a compensation committee composed solely of independent directors. In addition, the CEO may not be present during voting or deliberations concerning the determination of the CEO’s compensation. As with the Nasdaq corporate governance requirements generally, non-U.S. companies may obtain an exemption from this requirement.

---


(Public Co., Rel. #2, 11/10) 5–3
Unlike the NYSE listing standards, a formal written compensation committee charter is not required and the rules do not expressly contemplate delegation (although the wording of the rule would permit delegation).

**SUMM 5:5 SEC Corporate Governance Disclosure Relating to Compensation Committees**

Under SEC rules, a U.S. company is required to include in its proxy statement the following disclosure regarding its compensation committee and compensation process:

- A description of the processes and procedures it employs for the consideration of both executive officer and director compensation, including the scope of the authority of the compensation committee.
- Any role executive officers play in determining the amount and form of executive and director compensation.
- The name of any compensation consultant involved in determining or recommending the amount or form of executive or director compensation, together with the nature and scope of the assignment and the material elements of the instructions or directions given.
- The existence and details of any compensation committee interlocks.
- A Compensation Committee Report.

**SUMM 5:6 Additional Compensation Committee Independence Considerations**

In light of the actions generally within the purview of compensation committees, the independence standards of Rule 16b-3 under the Exchange Act and section 162(m) of the Internal Revenue Code are often relevant to compensation committee members. The standards under these provisions effectively impose two additional layers of independence requirements for compensation committee members.

**SUMM 5:7 Proposed Legislation to Heighten Independence Standards**

There have been a number of recent initiatives to increase the independence and accountability of compensation committee members. On July 31, 2009, the House of Representatives passed the Corporate and Financial Institution Compensation Fairness Act of
2009, which among other things would require additional independence standards for public company compensation committees.

§ 5:1 Dodd-Frank Act Compensation Committee Requirements

§ 5:1.1 Overview

On July 21, 2010, President Obama signed into law the Dodd-Frank Act, which included revisions to the independence requirements for compensation committees. In particular, section 952 adds a new section 10C to the Exchange Act, which requires the SEC to promulgate rules requiring national securities exchanges to prohibit the listing of an issuer’s equity securities if its board does not have an independent compensation committee.

§ 5:1.2 Relevant Text of the Dodd-Frank Act

SEC. 952. COMPENSATION COMMITTEE INDEPENDENCE.

(a) IN GENERAL.—The Securities Exchange Act of 1934 (15 U.S.C. 78 et seq.) is amended by inserting after section 10B, as added by section 753, the following:

SEC. 10C. COMPENSATION COMMITTEES.

(a) INDEPENDENCE OF COMPENSATION COMMITTEES.—

(1) LISTING STANDARDS.—The Commission shall, by rule, direct the national securities exchanges and national securities associations to prohibit the listing of any equity security of an issuer, other than an issuer that is a controlled company, limited partnership, company in bankruptcy proceedings, openended management investment company that is registered under the Investment Company Act of 1940, or a foreign private issuer that provides annual disclosures to shareholders of the reasons that the foreign private issuer does not have an independent compensation committee, that does not comply with the requirements of this subsection.

(2) INDEPENDENCE OF COMPENSATION COMMITTEES.—The rules of the Commission under paragraph (1) shall require that each member of the compensation committee of the board of directors of an issuer be—
§ 5:1.2  PUBLIC COMPANY DESKBOOK

(A) a member of the board of directors of the issuer; and

(B) independent.

(3) INDEPENDENCE.—The rules of the Commission under paragraph (1) shall require that, in determining the definition of the term ‘independence’ for purposes of paragraph (2), the national securities exchanges and the national securities associations shall consider relevant factors, including—

(A) the source of compensation of a member of the board of directors of an issuer, including any consulting, advisory, or other compensatory fee paid by the issuer to such member of the board of directors; and

(B) whether a member of the board of directors of an issuer is affiliated with the issuer, a subsidiary of the issuer, or an affiliate of a subsidiary of the issuer.

(4) EXEMPTION AUTHORITY.—The rules of the Commission under paragraph (1) shall permit a national securities exchange or a national securities association to exempt a particular relationship from the requirements of paragraph (2), with respect to the members of a compensation committee, as the national securities exchange or national securities association determines is appropriate, taking into consideration the size of an issuer and any other relevant factors.

(b) INDEPENDENCE OF COMPENSATION CONSULTANTS AND OTHER COMPENSATION COMMITTEE ADVISERS.—

(1) IN GENERAL.—The compensation committee of an issuer may only select a compensation consultant, legal counsel, or other adviser to the compensation committee after taking into consideration the factors identified by the Commission under paragraph (2).

(2) RULES.—The Commission shall identify factors that affect the independence of a compensation consultant, legal counsel, or other adviser to a compensation committee of an issuer. Such factors shall be competitively neutral among categories of consultants, legal counsel, or other advisers and preserve the ability of compensation commit-
Compensation Committee

§ 5:1.2

tees to retain the services of members of any such category, and shall include—

(A) the provision of other services to the issuer by the person that employs the compensation consultant, legal counsel, or other adviser;

(B) the amount of fees received from the issuer by the person that employs the compensation consultant, legal counsel, or other adviser, as a percentage of the total revenue of the person that employs the compensation consultant, legal counsel, or other adviser;

(C) the policies and procedures of the person that employs the compensation consultant, legal counsel, or other adviser that are designed to prevent conflicts of interest;

(D) any business or personal relationship of the compensation consultant, legal counsel, or other adviser with a member of the compensation committee; and

(E) any stock of the issuer owned by the compensation consultant, legal counsel, or other adviser.

(c) COMPENSATION COMMITTEE AUTHORITY RELATING TO COMPENSATION CONSULTANTS.—

(1) AUTHORITY TO RETAIN COMPENSATION CONSULTANT.—

(A) IN GENERAL.—The compensation committee of an issuer, in its capacity as a committee of the board of directors, may, in its sole discretion, retain or obtain the advice of a compensation consultant.

(B) DIRECT RESPONSIBILITY OF COMPENSATION COMMITTEE.—The compensation committee of an issuer shall be directly responsible for the appointment, compensation, and oversight of the work of a compensation consultant.

(C) RULE OF CONSTRUCTION.—This paragraph may not be construed—
§ 5:1.2  PUBLIC COMPANY DESKBOOK

(i) to require the compensation committee to implement or act consistently with the advice or recommendations of the compensation consultant; or

(ii) to affect the ability or obligation of a compensation committee to exercise its own judgment in fulfillment of the duties of the compensation committee.

(2) DISCLOSURE.—In any proxy or consent solicitation material for an annual meeting of the shareholders (or a special meeting in lieu of the annual meeting) occurring on or after the date that is 1 year after the date of enactment of this section, each issuer shall disclose in the proxy or consent material, in accordance with regulations of the Commission, whether—

(A) the compensation committee of the issuer retained or obtained the advice of a compensation consultant; and

(B) the work of the compensation consultant has raised any conflict of interest and, if so, the nature of the conflict and how the conflict is being addressed.

(d) AUTHORITY TO ENGAGE INDEPENDENT LEGAL COUNSEL AND OTHER ADVISERS.—

(1) IN GENERAL.—The compensation committee of an issuer, in its capacity as a committee of the board of directors, may, in its sole discretion, retain and obtain the advice of independent legal counsel and other advisers.

(2) DIRECT RESPONSIBILITY OF COMPENSATION COMMITTEE.—The compensation committee of an issuer shall be directly responsible for the appointment, compensation, and oversight of the work of independent legal counsel and other advisers.

(3) RULE OF CONSTRUCTION.—This subsection may not be construed—

(A) to require a compensation committee to implement or act consistently with the advice or recommendations of independent legal counsel or other advisers under this subsection; or
(B) to affect the ability or obligation of a compensation committee to exercise its own judgment in fulfillment of the duties of the compensation committee.

(e) COMPENSATION OF COMPENSATION CONSULTANTS, INDEPENDENT LEGAL COUNSEL, AND OTHER ADVISERS.—Each issuer shall provide for appropriate funding, as determined by the compensation committee in its capacity as a committee of the board of directors, for payment of reasonable compensation—

(1) to a compensation consultant; and

(2) to independent legal counsel or any other adviser to the compensation committee.

(f) COMMISSION RULES.—

(1) IN GENERAL.—Not later than 360 days after the date of enactment of this section, the Commission shall, by rule, direct the national securities exchanges and national securities associations to prohibit the listing of any security of an issuer that is not in compliance with the requirements of this section.

(2) OPPORTUNITY TO CURE DEFECTS.—The rules of the Commission under paragraph (1) shall provide for appropriate procedures for an issuer to have a reasonable opportunity to cure any defects that would be the basis for the prohibition under paragraph (1), before the imposition of such prohibition.

(3) EXEMPTION AUTHORITY.—

(A) IN GENERAL.—The rules of the Commission under paragraph (1) shall permit a national securities exchange or a national securities association to exempt a category of issuers from the requirements under this section, as the national securities exchange or the national securities association determines is appropriate.

(B) CONSIDERATIONS.—In determining appropriate exemptions under subparagraph (A), the national securities exchange or the national securities association shall take into account the potential impact of the requirements of this section on smaller reporting issuers.
§ 5:1.3  PUBLIC COMPANY DESKBOOK

(g) CONTROLLED COMPANY EXEMPTION.—

(1) IN GENERAL.—This section shall not apply to any controlled company.

(2) DEFINITION.—For purposes of this section, the term 'controlled company' means an issuer—

(A) that is listed on a national securities exchange or by a national securities association; and

(B) that holds an election for the board of directors of the issuer in which more than 50 percent of the voting power is held by an individual, a group, or another issuer.

(b) STUDY AND REPORT.—

(1) STUDY.—The Securities and Exchange Commission shall conduct a study and review of the use of compensation consultants and the effects of such use.

(2) REPORT.—Not later than 2 years after the date of the enactment of this Act, the Commission shall submit a report to Congress on the results of the study and review required by this subsection.

§ 5:1.3  Discussion of the Requirements

[A] Compensation Committee Independence

In determining the definition of independence, the Dodd-Frank Act mandates that the SEC rules must require the national securities exchanges to consider (1) the source of director compensation, including any consulting, advisory or other compensatory fee paid to the director by the issuer and (2) whether the director is affiliated with the issuer, a subsidiary of the issuer or an affiliate of a subsidiary of the issuer.2 While these two independence factors are similar to the factors identified in section 10A(m) of the Exchange Act with

---

2. The SEC may, but is not required to, include additional factors to be considered in determining a director’s independence. In addition, the SEC rules may permit national securities exchanges to provide exemptions from the independence requirements for a category of issuers, taking into account especially the potential impact on smaller issuers.
respect to the independence of audit committee members, the audit committee statute provides flatly that these relationships are a bar to the independence of an audit committee member. Thus, though the language of section 952 seems to provide greater flexibility, it remains possible that the rules will ultimately define independence in a manner that is more restrictive than the NYSE and Nasdaq independence requirements currently applicable to compensation committee members of U.S. listed companies. In particular, the reference to “affiliate” status raises the question of whether significant share ownership, which would not necessarily be a bar to independence under the current stock exchange rules, could present an independence issue under the rules implementing section 952.3

[B] Additional Disclosure Under the Dodd-Frank Act

[B][1] Background

Section 952 of the Dodd-Frank Act added a new section 10C to the Exchange Act, which requires the SEC and stock exchanges to impose additional procedural and disclosure requirements with respect to the use of compensation consultants, counsel and other advisors by listed companies (other than controlled companies). The rules required under this section must be issued within 360 days after the enactment of the Dodd-Frank Act.

[B][2] Discussion of the Additional Disclosure Under the Dodd-Frank Act

New section 10C requires an issuer’s proxy or consent solicitation materials for any meeting occurring one year after the enactment of the Dodd-Frank Act to disclose whether the compensation committee has retained, or obtained the advice of, a compensation consultant, whether the work of the compensation consultant has

3. These independence requirements will not apply to the following:
   • a “controlled company,” which is a listed company that has more than 50 percent of its voting power held by an individual, a group or another issuer;
   • foreign private issuers that provide annual disclosure to shareholders of reasons that they do not have an independent compensation committee;
   • limited partnerships;
   • companies in bankruptcy proceedings;
   • open-end management investment companies registered under the Investment Company Act; or
   • companies that list only debt securities, not equity securities.
§ 5:2

PUBLIC COMPANY DESKBOOK

raised any conflict of interest and, if so, the nature of the conflict and the manner in which the conflict is being addressed. ¹

§ 5:2 NYSE Compensation Committee Requirements

§ 5:2.1 Overview

The NYSE rules adopted in 2003 as part of the NYSE’s enhanced corporate governance listing standards⁵ require each listed company to establish a compensation committee composed entirely of independent directors. See section 3:1.2 for a discussion of the background and adoption of the enhanced stock exchange listing standards in 2003.

---

4. In addition, the compensation committee must have authority to engage, and the funds to pay, consultants, counsel and advisors. Consultants, counsel and advisors are not required to be independent, but the compensation committee must consider factors affecting independence before making a selection. The relevant factors are to be identified by the SEC and must include the business and personal relationships between the consultant, counsel or advisor and a member of the compensation committee, and the relationships between the employer of such consultant, counsel or advisor and the issuer. Section 952 specifies that such factors must be “competitively neutral among categories of consultants, legal counsel, or other advisers and preserve the ability of compensation committees to retain the services of members of any such category.” The compensation committee must have direct responsibility for the appointment, compensation and oversight of the work of the compensation consultant, counsel or advisor.

Compensation Committee § 5:2.2

§ 5:2.2 Text of Section 303A.05 (Including NYSE Commentary)

[The NYSE rules were issued with an accompanying official commentary that should be considered part of the rules. The following reflects the rules and commentary as of March 1, 2010, including minor changes to the rule text that became effective January 1, 2010.6]

303A.05 Compensation Committee

(a) Listed companies must have a compensation committee composed entirely of independent directors.

(b) The compensation committee must have a written charter that addresses:

(i) the committee’s purpose and responsibilities—which, at minimum, must be to have direct responsibility to:

(A) review and approve corporate goals and objectives relevant to CEO compensation, evaluate the CEO’s performance in light of those goals and objectives, and, either as a committee or together with the other independent directors (as directed by the board), determine and approve the CEO’s compensation level based on this evaluation;

(B) make recommendations to the board with respect to non-CEO executive officer compensation, and incentive-compensation and equity-based plans that are subject to board approval; and

(C) prepare the disclosure required by Item 407(e)(5) of Regulation S-K;

(ii) an annual performance evaluation of the compensation committee.

Commentary: In determining the long-term incentive component of CEO compensation, the committee should consider the listed company’s performance and relative shareholder return, the value of similar incentive awards to CEOs at comparable companies, and the awards given to the listed company’s CEO in past years. To avoid confusion, note that the compensation committee is not precluded from approving awards (with or without ratification of the board) as may be required to comply with applicable tax laws (i.e., Rule 162(m)). Note also that nothing in Section 303A.05(b)(ii)(B) is intended to preclude the board from delegating its authority over such matters to the compensation committee.

The compensation committee charter should also address the following items: committee member qualifications; committee member appointment and removal; committee structure and operations (including authority to delegate to subcommittees); and committee reporting to the board.

Additionally, if a compensation consultant is to assist in the evaluation of director, CEO or executive officer compensation, the compensation committee charter should give that committee sole authority to retain and terminate the consulting firm, including sole authority to approve the firm’s fees and other retention terms.

Boards may allocate the responsibilities of the compensation committee to committees of their own denomination, provided that the committees are composed entirely of independent directors. Any such committee must have a committee charter.

Nothing in this provision should be construed as precluding discussion of CEO compensation with the board generally, as it is not the intent of this standard to impair communication among members of the board.

Website Posting Requirement: A listed company must make its compensation committee charter available on or through its website. If any function of the compensation committee has been delegated to another committee, the charter of that committee must also be made available on or through the listed company’s website.

Disclosure Requirements: A listed company must disclose in its annual proxy statement or, if it does not file an annual proxy statement, in its annual report on Form 10-K filed with the SEC.
that its compensation committee charter is available on or through its website and provide the website address.

§ 5:2.3 Discussion of the Rule

Under the NYSE listing standards, each U.S. listed company must have a compensation committee composed of independent directors.

See section 3:1.3[B] for a discussion of the timing of effectiveness of the NYSE compensation committee requirements, including phase-in periods for IPO companies and other newly listed companies. See sections 3:1.3[C] and [D] for a discussion of the entities subject to the rule. As discussed in those sections, non-U.S. companies, controlled companies, limited partnerships and companies in bankruptcy proceedings are exempt from this requirement.

The compensation committee must have a written charter, which must be posted on the company’s website, addressing (at a minimum) the committee’s purpose and responsibilities, which must be to have direct responsibility for:

- reviewing and approving the corporate goals and objectives relevant to CEO compensation, evaluating the CEO’s performance in light of those goals and objectives and, either as a committee or together with the other independent directors (as directed by the board), determining and approving the compensation of the CEO based on this evaluation;
- making recommendations to the board (or discharging the board’s responsibilities) with respect to non-CEO executive officer compensation, incentive-compensation and equity-based plans that are subject to board approval;
- producing the annual report on executive compensation; and
- performing an annual performance evaluation of the committee.\(^7\)

The rules recommend (but do not require) that the charter also address:

- committee member qualification, appointment and removal;
- committee structure and operations;
- committee reporting to the board; and
- the sole authority of the committee to retain, terminate and approve the fees and retention terms of any compensation consultant.

\(^7\) See section 8:1.3 for a discussion of a possible approach for conducting this self-evaluation.
§ 5:2.4  

PUBLIC COMPANY DESKBOOK

The rules permit delegation to subcommittees. Companies should consider expressly allowing the compensation committee to delegate the approval of transactions to a subcommittee where necessary to satisfy the approval requirements of Rule 16b-3 under the Exchange Act and/or section 162(m) of the Internal Revenue Code.

Each of Rule 16b-3 and section 162(m) provides for actions to be taken by non-employee or outside directors in connection with certain compensation matters. Rule 16b-3 provides an exemption from short-swing profit recovery under section 16 of the Exchange Act for, among other things, transactions between issuers and their directors and officers that are approved by a committee of the board that consists solely of two or more “non-employee directors.” Section 162(m) exempts certain performance-based compensation from the cap on deductibility if a compensation committee composed of two or more “outside directors” determines and certifies the relevant performance goals. Because the criteria set forth in Rule 16b-3 and section 162(m) vary somewhat from the NYSE independence requirements, it is possible for a compensation committee member who is independent for NYSE purposes to fail to be a “non-employee director” under Rule 16b-3 or an “outside director” under section 162(m). In that case, delegation to a subcommittee composed of directors meeting the relevant definition would be necessary to meet the requirements of these provisions.8 Section 5:4 discusses the independence requirements of Rule 16b-3 and section 162(m) in more detail.

The NYSE listing standards expressly permit the responsibilities of the compensation committee to be allocated to one or more other committees composed entirely of independent directors. These other committees would need to have written charters posted on the company’s website, including the provisions required for the compensation committee’s charter.

§ 5:2.4  Sample Compensation Committee Charter for NYSE-Listed U.S. Companies

The following is an annotated sample form of compensation committee charter that NYSE-listed U.S. companies can use as a starting point to create or modify their own. The annotations indicate the NYSE rule or other legal requirement upon which the relevant provision is based. The underlying form of compensation committee charter is for illustrative purposes only and should be tailored to fit the particular circumstances of each company.

8. See the section entitled “Delegation to Subcommittee” in the sample Compensation Committee Charter contained in section 5:2.4 for suggested language specifically permitting this delegation.
Committee Membership

The Compensation Committee (the “Committee”) of the Board of Directors (the “Board”) of [Name of Corporation] (the “Company”) shall consist solely of three or more members of the Board, each of whom the Board has determined has no material relationship with the Company and each of whom is otherwise “independent” under the rules of the New York Stock Exchange, Inc. [NYSE 303A.02 and .05(a)]

Members shall be appointed by the Board [based on nominations recommended by the Company’s Nominating Committee]. Members shall serve at the pleasure of the Board and for such term or terms as the Board may determine. [Discuss qualifications for committee members.] [NYSE 303A.05 (commentary recommends, but does not require, that charter address committee member qualifications, appointment and removal)]

Committee Purpose and Responsibilities

The Committee shall have the purpose and direct responsibility to:

1. Review and approve corporate goals and objectives relevant to the compensation of the Company’s Chief Executive Officer (“CEO”), evaluate the CEO’s performance in light of those goals and objectives, and either as a committee or together with the other independent directors (as directed by the Board), determine and approve the CEO’s compensation level based on this evaluation [NYSE 303A.05(b)(i)(A)]. In determining the long-term incentive component of CEO compensation, the Committee shall consider, among other factors, the Company’s performance and relative shareholder return, the value of similar incentive awards to CEOs at comparable companies, the awards given to the CEO in past years, and [list other factors, if any]. [NYSE 303A.05 (commentary recommends, but does not require, that the committee consider these factors)]

2. [Make recommendations to] [Discharge the responsibilities of] the Board with respect to non-CEO executive officer compensation, incentive-compensation plans and equity-based plans that are subject to board approval [, including [list specific plans currently in existence], oversee the activities of the individuals and committees responsible for administering these plans, including [list specific committees to be overseen], and discharge any responsibilities imposed on the Committee by any of these plans]. [NYSE 303A.05(b)(i)(B)]
3. Approve any new equity compensation plan or any material change to an existing plan where shareholder approval has not been obtained. [NYSE 303A.08 (commentary)]

4. In consultation with management, oversee regulatory compliance with respect to compensation matters, including overseeing the Company’s policies on structuring compensation programs to preserve tax deductibility, and, as and when required, establishing performance goals and certifying that performance goals have been attained for purposes of Section 162(m) of the Internal Revenue Code. [NYSE 303A.05 (commentary notes committee may approve awards pursuant to 162(m))]

[5. Make recommendations to the Board with respect to any severance or similar termination payments proposed to be made to any current or former [executive officer] [member of senior management] of the Company.]

6. Prepare an annual Compensation Committee Report for inclusion in the Company’s annual proxy statement in accordance with applicable SEC rules and regulations. [NYSE 303A.05(b)(i)(C) and Item 407(e)(5) (Compensation Committee Report) of Regulation S-K]

7. Prepare and issue the evaluation required under “Performance Evaluation” below. [NYSE 303A.05(b)(i)(C) and (ii)]

8. Report to the Board on a regular basis, and not less than once per year. [NYSE 303A.05 (commentary recommends, but does not require, that charter address committee reporting to the Board)]

9. Perform any other duties or responsibilities expressly delegated to the Committee by the Board from time to time relating to the Company’s compensation programs.

**Committee Structure and Operations**

The [Board] [Committee] shall designate one member of the Committee as its chairperson. [In the event of a tie vote on any issue, the chairperson’s vote shall decide the issue.] The Committee shall meet at least [three times] a year at a time and place determined by the Committee chairperson, with further meetings to occur, or actions to be taken by unanimous written consent, when deemed necessary or desirable by the Committee or its chairperson. Members of the Committee may participate in a
Compensation Committee § 5:2.4

meeting of the Committee by means of conference call or similar communications equipment by means of which all persons participating in the meeting can hear each other. [NYSE 303A.05 (commentary recommends, but does not require, that charter address committee structure and operations)]

[The Committee may invite such members of management to its meetings as it deems appropriate, consistent with the maintenance of the confidentiality of compensation discussions. The CEO should not attend any meeting where the CEO’s performance or compensation is discussed, unless specifically invited by the Committee. [NYSE 303A.04 (commentary recommends, but does not require, that charter address committee structure and operations)]

Delegation to Subcommittee

The Committee may, in its discretion, delegate all or a portion of its duties and responsibilities to a subcommittee of the Committee. In particular, the Committee may delegate the approval of certain transactions to a subcommittee consisting solely of members of the Committee who are (i) “Non-Employee Directors” for the purposes of Rule 16b-3 under the Securities Exchange Act of 1934, as in effect from time to time, and (ii) “outside directors” for the purposes of Section 162(m) of the Internal Revenue Code, as in effect from time to time. [NYSE 303A.05 (commentary recommends, but does not require, that charter address delegation to subcommittees)]

Performance Evaluation

The Committee shall prepare and review with the Board an annual performance evaluation of the Committee, which evaluation shall compare the performance of the Committee with the requirements of this charter. The performance evaluation shall also recommend to the Board any improvements to the Committee’s charter deemed necessary or desirable by the Committee. The performance evaluation by the Committee shall be conducted in such manner as the Committee deems appropriate. The report to the Board may take the form of an oral report by the chairperson of the Committee or any other member of the Committee designated by the Committee to make this report. [NYSE 303A.05(b)(ii)]
§ 5:3 Resources and Authority of the Committee

The Committee shall have the resources and authority appropriate to discharge its duties and responsibilities, including the authority to select, retain, terminate, and approve the fees and other retention terms of special counsel or other experts or consultants, as it deems appropriate, without seeking approval of the Board or management. With respect to compensation consultants retained to assist in the evaluation of director, CEO or senior executive compensation, this authority shall be vested solely in the Committee. [NYSE 303A.05 (commentary recommends, but does not require, that charter give the committee such authority)]

§ 5:3 Nasdaq Rules Relating to Executive Compensation

§ 5:3.1 Overview

In 2003, as part of its adoption of enhanced corporate governance listing standards, Nasdaq adopted rules requiring oversight by independent directors of executive officer compensation. See section 3:1.2 for a discussion of the background and adoption of the enhanced stock exchange listing standards in 2003.

§ 5:3.2 Text of Rule 5605(d) (Including Interpretations)

[The Nasdaq rules were issued with an accompanying official interpretation that should be considered part of the rules. In April 2009, new Nasdaq rules became effective that reorganized the rules relating to the qualification, listing, and delisting of companies, but no substantive changes were made to the rules.]

Rule 5605. Board of Directors and Committees

* * * *

(d) Independent Director Oversight of Executive Officer Compensation

9. See Rel. No. 34-48745, supra note 5.
Compensation Committee  § 5:3.2

(1) Compensation of the chief executive officer of the Company must be determined, or recommended to the Board for determination, either by:

(A) Independent Directors constituting a majority of the Board's Independent Directors in a vote in which only Independent Directors participate; or

(B) a compensation committee comprised solely of Independent Directors.

The chief executive officer may not be present during voting or deliberations.

(2) Compensation of all other Executive Officers must be determined, or recommended to the Board for determination, either by:

(A) Independent Directors constituting a majority of the Board's Independent Directors in a vote in which only Independent Directors participate; or

(B) a compensation committee comprised solely of Independent Directors.

(3) Non-Independent Committee Member under Exceptional and Limited Circumstances

Notwithstanding paragraphs 5605(d)(1)(B) and 5605(d)(2)(B) above, if the compensation committee is comprised of at least three members, one director who is not independent as defined in Rule 5605(a)(2) and is not a current officer or employee or a Family Member of an officer or employee, may be appointed to the compensation committee 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, and the board discloses, in the proxy statement for the next annual meeting subsequent to such determination (or, if the Company does not file a proxy, in its Form 10-K or 20-F), the nature of the relationship and the reasons for the determination. A mem-

11. The Nasdaq definition of Independent Director is set forth in section 3:1.4[A] and discussed in section 3:1.4[G].
§ 5:3.3  PUBLIC COMPANY DESKBOOK

ber appointed under this exception may not serve longer than two years.

IM-5605-6. Independent Director Oversight of Executive Compensation

Independent director oversight of executive officer compensation helps assure that appropriate incentives are in place, consistent with the board’s responsibility to maximize shareholder value. The rule is intended to provide flexibility for a Company to choose an appropriate board structure and to reduce resource burdens, while ensuring Independent Director control of compensation decisions.

§ 5:3.3  Discussion of the Rule

See section 3:1.4[B] for a discussion of the timing of effectiveness of the Nasdaq requirements relating to executive compensation, including phase-in periods for IPO companies and other newly listed companies. See sections 3:1.4[C] and [D] for a discussion of the entities subject to the rule, including the availability of an exemption for non-U.S. issuers.

The Nasdaq independence rules require that the compensation of the CEO and officers of each listed company (other than controlled companies) be determined, or recommended to the board for determination, by either (i) a majority of the independent directors, or (ii) a compensation committee composed solely of independent directors (subject to the exception described in the next paragraph). The CEO may not be present during voting or deliberations concerning the determination of the CEO’s compensation.

The rules provide that if the compensation committee is composed of at least three members, then one non-independent director can be appointed to the committee if the director is not a current officer or employee of the company or a family member thereof, and the board of directors, under exceptional and limited circumstances,

12. “Officer” is defined by reference to Rule 16a-1 under the Exchange Act as “an issuer’s president, principal financial officer, principal accounting officer (or, if there is no such accounting officer, the controller), any vice-president of the issuer in charge of a principal business unit, division or function [such as sales, administration or finance], any other officer who performs a policy-making function, or any other person who performs similar policy-making functions for the issuer.”

13. See section 3:1.4[E] for a definition of this term and a description of the disclosure required if this exception is used.

14. See chapter 3, note 65 for Nasdaq’s definition of “family member.”

5–22
determines that the individual’s membership on the committee is required by the best interests of the company and its shareholders. A member appointed under this exception may not serve longer than two years. If this exception is used, the board of directors must disclose the nature of the relationship and the reasons for the determination in the next annual meeting proxy statement after the determination.

Unlike the NYSE rule, the Nasdaq rule does not specifically state that delegation to a subcommittee is permitted. The wording of the requirement would, however, permit delegation, since a subcommittee of an independent compensation committee would necessarily be a committee composed of independent directors. In particular, the rule would seem to permit a standing independent compensation committee to delegate responsibilities to a subcommittee composed of directors satisfying the standards of Rule 16b-3 under the Exchange Act and/or section 162(m) of the Internal Revenue Code.\(^\text{15}\)

\section*{§ 5:3.4 Sample Compensation Committee Charter for Nasdaq-Listed U.S. Companies}

The following is an annotated sample form of compensation committee charter that Nasdaq-listed U.S. companies can use as a starting point to create or modify their own. The annotations indicate the Nasdaq rule or other legal requirement upon which the relevant provision is based. The underlying form of compensation committee charter is for illustrative purposes only and should be tailored to fit the particular circumstances of each company.

\subsection*{Committee Membership}

Except as [provided below,] [permitted by Nasdaq Rule 5605(d),] the Compensation Committee (the “Committee”) of the Board of Directors (the “Board”) of [Name of Corporation] (the “Company”) shall consist solely of “independent directors,” i.e., those directors who neither are officers or employees of the Company or its subsidiaries nor have a relationship which, in the opinion of the Board, would interfere with the exercise of independent judgment in carrying out the responsibilities of a director, and who are otherwise “independent” under the rules of the Nasdaq Stock Market, Inc. [Nasdaq 5605(d)(1)]

\footnote{\text{15. See section 5:5 for a discussion of Rule 16b-3 and § 162(m) and the reasons delegation may be necessary. See the section entitled “Delegation to Subcommittee” in the Sample Compensation Committee Charter contained in section 5:3.4 for suggested language specifically permitting this delegation.}}

\text{(Public Co., Rel. #2, 11/10) 5–23}
Members shall be appointed by the Board [based on nominations by the Company’s [Corporate Governance and] Nominations Committee] [Nasdaq 5605(e)(1)]. Members shall serve at the pleasure of the Board and for such term or terms as the Board may determine. [Discuss qualifications for committee members.]

[If the Committee is comprised of at least three members, one director who is not independent and is not a current officer or employee, or a spouse, parent, child or sibling, whether by blood, marriage or adoption, of, or a person who has the same residence as, any current officer or employee, may be appointed to the Committee 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 stockholders, and the Board discloses, in the next annual meeting proxy statement [(or [Form 10-K] [Form 20-F] if no proxy statement is filed)] subsequent to such determination, the nature of the relationship between the director and the company, and the reasons for the determination. Any such member appointed to the Committee may only serve for up to two years. [Nasdaq 4350(d)(3)] [May be included if applicable.]

Committee Purpose and Responsibilities

The Committee shall have the purpose and direct responsibility to:

1. Review and approve corporate goals and objectives relevant to the compensation of the Company’s Chief Executive Officer (“CEO”), evaluate the CEO’s performance in light of those goals and objectives, and either as a committee or together with the other independent directors (as directed by the Board), determine, or recommend to the Board for determination, the CEO’s compensation level based on this evaluation [Nasdaq 5605(d)(1)]. In determining or recommending the long-term incentive component of CEO compensation, the Committee shall consider, among other factors, the Company’s performance and relative shareholder return, the value of similar incentive awards to CEOs at comparable companies, the awards given to the CEO in past years, and [list other factors, if any].

2. Either as a committee or together with the other independent directors (as directed by the Board), determine, or recommend to the Board for determination, the compensation of all other executive officers of the Company. [Nasdaq 5605(d)(2)]
3. [Make recommendations to] [Discharge the responsibilities of] the Board with respect to the Company’s incentive compensation plans and equity-based plans[, including [list specific plans currently in existence], oversee the activities of the individuals and committees responsible for administering these plans, including [list specific committees to be overseen], and discharge any responsibilities imposed on the Committee by any of these plans].

4. [Approve issuances under, or any material amendment of, any tax qualified, non-discriminatory employee benefit plan or parallel nonqualified plan pursuant to which a director, officer, employee or consultant will acquire stock or options.] [Nasdaq 5635(c)(3)]

5. [Approve issuances under, or any material amendment of, any stock option or other similar plan pursuant to which a person not previously an employee or director of the Company, as an inducement material to the individual’s entering into employment with the Company, will acquire stock or options.] [Nasdaq 5635(c)(4)]

6. In consultation with management, oversee regulatory compliance with respect to compensation matters, including overseeing the Company’s policies on structuring compensation programs to preserve tax deductibility, and, as and when required, establishing performance goals and certifying that performance goals have been attained for purposes of Section 162(m) of the Internal Revenue Code.

7. To review and approve any severance or similar termination payments proposed to be made to any current or former executive officer of the Company.

8. Prepare an annual Compensation Committee Report for inclusion in the Company’s annual proxy statement in accordance with applicable SEC rules and regulations. [NYSE 5(b)(ii)(C) and Item 407(e)(5) (Compensation Committee Report) of Regulation S-K]

9. [Prepare and issue the evaluation required under “Performance Evaluation” below.]

10. [Report to the Board on a regular basis, and not less than once per year.]
11. Perform any other duties or responsibilities expressly delegated to the Committee by the Board from time to time relating to the Company’s compensation programs.

Committee Structure and Operations

The [Board] [Committee] shall designate one member of the Committee as its chairperson. [In the event of a tie vote on any issue, the chairperson’s vote shall decide the issue.] The Committee shall meet at least [twice] a year, and perhaps more frequently, in conjunction with regularly scheduled meetings of the Board at regularly scheduled times and places determined by the Committee chairperson, with further meetings to occur, or actions to be taken by unanimous written consent, when deemed necessary or desirable by the Committee or its chairperson [Nasdaq IM-5605-1 provides that Nasdaq contemplates that executive sessions of the independent directors will occur at least twice a year, and perhaps more frequently, in conjunction with regularly scheduled board meetings]. Members of the Committee may participate in a meeting of the Committee by means of conference call or similar communications equipment by means of which all persons participating in the meeting can hear each other.

The CEO may not be present during any voting or deliberations of the Committee regarding the CEO’s compensation. [Nasdaq 5605(d)(2)]

Delegation to Subcommittee

The Committee may, in its discretion, delegate all or a portion of its duties and responsibilities to a subcommittee of the Committee consisting of one or more members. In particular, the Committee may delegate the approval of certain transactions to a subcommittee consisting solely of members of the Committee who are (i) “Non-Employee Directors” for the purposes of Rule 16b-3 under the Securities Exchange Act of 1934, as in effect from time to time, and (ii) “outside directors” for the purposes of Section 162(m) of the Internal Revenue Code, as in effect from time to time.

[Performance Evaluation]

The Committee shall prepare and review with the Board an annual performance evaluation of the Committee, which evalua-
Compensation Committee

§ 5:4.1

The preparation of a performance evaluation is optional for Nasdaq-listed companies but NYSE-listed companies are required to produce an annual performance evaluation, and the NYSE rules recommend that the compensation committee charter address reporting to the board. Nasdaq-listed companies may wish to consider adopting these requirements or providing a similar report.

16. The preparation of a performance evaluation is optional for Nasdaq-listed companies but NYSE-listed companies are required to produce an annual performance evaluation, and the NYSE rules recommend that the compensation committee charter address reporting to the board. Nasdaq-listed companies may wish to consider adopting these requirements or providing a similar report.

compensation committees, were consolidated under Item 407 of Regulation S-K. Recent rule changes that took effect February 28, 2010 expanded the disclosure requirements relating to the use of compensation consultants.

Item 407 also includes disclosure requirements relating to director independence and board and committee functioning, which are discussed in section 3:2.

The SEC’s compensation committee disclosure rules, like the rest of the executive compensation rules, do not apply to non-U.S. issuers. The compensation committee disclosure rules also do not apply to registered investment companies. Registered investment companies have a separate, abbreviated disclosure regime. 18

§ 5:4.2 Text of SEC Rules Relating to Compensation Committees

[A] Item 407(e) of Regulation S-K

(e) Compensation committee. (1) If the registrant does not have a standing compensation committee or committee performing similar functions, state the basis for the view of the board of directors that it is appropriate for the registrant not to have such a committee and identify each director who participates in the consideration of executive officer and director compensation.

(2) State whether or not the compensation committee has a charter. If the compensation committee has a charter, provide the disclosure required by Instruction 2 to this Item regarding the compensation committee charter.

(3) Provide a narrative description of the registrant’s processes and procedures for the consideration and determination of executive and director compensation, including:

(i)(A) The scope of authority of the compensation committee (or persons performing the equivalent functions); and

(B) The extent to which the compensation committee (or persons performing the equivalent functions) may delegate any authority described in paragraph (e)(3)(i)(A) of this Item to other persons, specifying what authority may be so delegated and to whom;

18. See Item 22(b)(13) of Schedule 14A.
Compensation Committee

(ii) Any role of executive officers in determining or recommending the amount or form of executive and director compensation; and

(iii) Any role of compensation consultants in determining or recommending the amount or form of executive and director compensation (other than any role limited to consulting on any broad-based plan that does not discriminate in scope, terms, or operation, in favor of executive officers or directors of the registrant, and that is available generally to all salaried employees; or providing information that either is not customized for a particular registrant or that is customized based on parameters that are not developed by the compensation consultant, and about which the compensation consultant does not provide advice) during the registrant's last completed fiscal year, identifying such consultants, stating whether such consultants were engaged directly by the compensation committee (or persons performing the equivalent functions) or any other person, describing the nature and scope of their assignment, and the material elements of the instructions or directions given to the consultants with respect to the performance of their duties under the engagement:

(A) If such compensation consultant was engaged by the compensation committee (or persons performing the equivalent functions) to provide advice or recommendations on the amount or form of executive and director compensation (other than any role limited to consulting on any broad-based plan that does not discriminate in scope, terms, or operation, in favor of executive officers or directors of the registrant, and that is available generally to all salaried employees; or providing information that either is not customized for a particular registrant or that is customized based on parameters that are not developed by the compensation consultant, and about which the compensation consultant does not provide advice) and the compensation consultant or its affiliates also provided additional services to the registrant or its affiliates in an amount in excess of $120,000 during the registrant's last completed fiscal year, then disclose the aggregate fees for determining or recommending the amount or form of executive and director compensation and the aggregate fees for such additional

(Public Co., Rel. #2, 11/10)
§ 5:4.2

PUBLIC COMPANY DESKBOOK

services. Disclose whether the decision to engage the compensation consultant or its affiliates for these other services was made, or recommended, by management, and whether the compensation committee or the board approved such other services of the compensation consultant or its affiliates.

(B) If the compensation committee (or persons performing the equivalent functions) has not engaged a compensation consultant, but management has engaged a compensation consultant to provide advice or recommendations on the amount or form of executive and director compensation (other than any role limited to consulting on any broad-based plan that does not discriminate in scope, terms, or operation, in favor of executive officers or directors of the registrant, and that is available generally to all salaried employees; or providing information that either is not customized for a particular registrant or that is customized based on parameters that are not developed by the compensation consultant, and about which the compensation consultant does not provide advice) and such compensation consultant or its affiliates has provided additional services to the registrant in an amount in excess of $120,000 during the registrant’s last completed fiscal year, then disclose the aggregate fees for determining or recommending the amount or form of executive and director compensation and the aggregate fees for any additional services provided by the compensation consultant or its affiliates. 19

(4) Under the caption “Compensation Committee Interlocks and Insider Participation”:

(i) Identify each person who served as a member of the compensation committee of the registrant’s board of directors (or board committee performing equivalent functions) during the last completed fiscal year, indicating each committee member who:

19. Subsection [iii], as shown, reflects rule changes that became effective February 28, 2010. See section 5:4.3[B] for a discussion of these changes.
Compensation Committee § 5:4.2

(A) Was, during the fiscal year, an officer or employee of the registrant;

(B) Was formerly an officer of the registrant; or

(C) Had any relationship requiring disclosure by the registrant under any paragraph of Item 404 (§ 229.404). In this event, the disclosure required by Item 404 (§ 229.404) shall accompany such identification.

(ii) If the registrant has no compensation committee (or other board committee performing equivalent functions), the registrant shall identify each officer and employee of the registrant, and any former officer of the registrant, who, during the last completed fiscal year, participated in deliberations of the registrant's board of directors concerning executive officer compensation.

(iii) Describe any of the following relationships that existed during the last completed fiscal year:

(A) An executive officer of the registrant served as a member of the compensation committee (or other board committee performing equivalent functions or, in the absence of any such committee, the entire board of directors) of another entity, one of whose executive officers served on the compensation committee (or other board committee performing equivalent functions or, in the absence of any such committee, the entire board of directors) of the registrant;

(B) An executive officer of the registrant served as a director of another entity, one of whose executive officers served on the compensation committee (or other board committee performing equivalent functions or, in the absence of any such committee, the entire board of directors) of the registrant; and

(C) An executive officer of the registrant served as a member of the compensation committee (or other board committee performing equivalent functions or, in the absence of any such committee, the entire board of directors) of another entity, one of whose
executive officers served as a director of the registrant.

(iv) Disclosure required under paragraph (e)(4)(iii) of this Item regarding a compensation committee member or other director of the registrant who also served as an executive officer of another entity shall be accompanied by the disclosure called for by Item 404 with respect to that person.

Instruction to Item 407(e)(4).

For purposes of paragraph (e)(4) of this Item, the term *entity* shall not include an entity exempt from tax under section 501(c)(3) of the Internal Revenue Code (26 U.S.C. 501(c)(3)).

(5) Under the caption “Compensation Committee Report:”

(i) The compensation committee (or other board committee performing equivalent functions or, in the absence of any such committee, the entire board of directors) must state whether:

(A) The compensation committee has reviewed and discussed the Compensation Discussion and Analysis required by Item 402(b) (§ 229.402(b)) with management; and

(B) Based on the review and discussions referred to in paragraph (e)(5)(i)(A) of this Item, the compensation committee recommended to the board of directors that the Compensation Discussion and Analysis be included in the registrant’s annual report on Form 10-K (§ 249.310 of this chapter), proxy statement on Schedule 14A (§ 240.14a-101 of this chapter) or information statement on Schedule 14C (§ 240.14c-101 of this chapter).

(ii) The name of each member of the registrant’s compensation committee (or other board committee performing equivalent functions or, in the absence of any such committee, the entire board of directors) must appear below the disclosure required by paragraph (e)(5)(i) of this Item.
Instructions to Item 407(e)(5).

1. The information required by paragraph (e)(5) of this Item shall not be deemed to be “soliciting material,” or to be “filed” with the Commission or subject to Regulation 14A or 14C (17 CFR 240.14a-1 through 240.14b-2 or 240.14c-1 through 240.14c-101), other than as provided in this Item, or to the liabilities of section 18 of the Exchange Act (15 U.S.C. 78r), except to the extent that the registrant specifically requests that the information be treated as soliciting material or specifically incorporates it by reference into a document filed under the Securities Act or the Exchange Act.

2. The disclosure required by paragraph (e)(5) of this Item need not be provided in any filings other than an annual report on Form 10-K (§ 249.310 of this chapter), a proxy statement on Schedule 14A (§ 240.14a-101 of this chapter) or an information statement on Schedule 14C (§ 240.14c-101 of this chapter). Such information will not be deemed to be incorporated by reference into any filing under the Securities Act or the Exchange Act, except to the extent that the registrant specifically incorporates it by reference. If the registrant elects to incorporate this information by reference from the proxy or information statement into its annual report on Form 10-K pursuant to General Instruction G(3) to Form 10-K, the disclosure required by paragraph (e)(5) of this Item will be deemed furnished in the annual report on Form 10-K and will not be deemed incorporated by reference into any filing under the Securities Act or the Exchange Act as a result of furnishing the disclosure in this manner.

3. The disclosure required by paragraph (e)(5) of this Item need only be provided one time during any fiscal year.

***

Instructions to Item 407.

1. For purposes of this Item:

***

2. With respect to paragraphs (c)(2)(i), (d)(1) and (e)(2) of this Item, disclose whether a current copy of the applicable committee charter is available to security holders on the registrant's
§ 5:4.2  PUBLIC COMPANY DESKBOOK

Web site, and if so, provide the registrant’s Web site address. If a current copy of the charter is not available to security holders on the registrant’s Web site, include a copy of the charter in an appendix to the registrant’s proxy or information statement that is provided to security holders at least once every three fiscal years, or if the charter has been materially amended since the beginning of the registrant’s last fiscal year. If a current copy of the charter is not available to security holders on the registrant’s Web site, and is not included as an appendix to the registrant’s proxy or information statement, identify in which of the prior fiscal years the charter was so included in satisfaction of this requirement.

[B] Items 7 and 8 of Schedule 14A

Item 7. Directors and Executive Officers.

If action is to be taken with respect to the election of directors, furnish the following information in tabular form to the extent practicable. If, however, the solicitation is made on behalf of persons other than the registrant, the information required need be furnished only as to nominees of the persons making the solicitation.

(a) The information required by Instruction 4 to Item 103 of Regulation S-K (§ 229.103 of this chapter) with respect to directors and executive officers.

(b) The information required by Items 401, 404(a) and (b), 405 and 407(d)(4), (d)(5) and (h) of Regulation S-K (§ 229.401, § 229.404(a) and (b), § 229.405 and § 229.407(d)(4), (d)(5) and (h) of this chapter).

(c) The information required by Item 407(a) of Regulation S-K (§ 229.407 of this chapter).

(d) The information required by Item 407(b), (c)(1), (c)(2), (d)(1), (d)(2), (d)(3), (e)(1), (e)(2), (e)(3) and (f) of Regulation S-K (§ 229.407(b), (c)(1), (c)(2), (d)(1), (d)(2), (d)(3), (e)(1), (e)(2), (e)(3) and (f) of this chapter).

(e) In lieu of the information required by this Item 7, investment companies registered under the Investment Company Act of 1940 (15 U.S.C. 80a) must furnish the information required by Item 22(b) of this Schedule 14A.
Item 8. Compensation of Directors and Executive Officers.

Furnish the information required by Item 402 of Regulation S-K and paragraphs (e)(4) and (e)(5) of Item 407 of Regulation S-K if action is to be taken with regard to:

(a) The election of directors;

(b) Any bonus, profit sharing or other compensation plan, contract or arrangement in which any director, nominee for election as a director, or executive officer of the registrant will participate;

(c) Any pension or retirement plan in which any such person will participate; or

(d) The granting or extension to any such person of any options, warrants or rights to purchase any securities, other than warrants or rights issued to security holders as such, on a pro rata basis.

However, if the solicitation is made on behalf of persons other than the registrant, the information required need be furnished only as to nominees of the persons making the solicitation and associates of such nominees. In the case of investment companies registered under the Investment Company Act of 1940 (15 U.S.C. 80a), furnish the information required by Item 22(b)(13) of this Schedule 14A.

§ 5:4.3 Compensation Committee Process

[A] Requirements Under 2006 Rule

The 2006 executive compensation rules modified and expanded the proxy statement disclosure relating to the compensation committee process. Under the SEC rules, a U.S. company is required to include in its proxy statement the following disclosure regarding its compensation committee and compensation process:

- Identification. A statement of whether there is a standing compensation committee or committee performing similar functions. If not, companies are required [1] to state the basis for the view of the board of directors as to why it is appropriate not to have such a committee, and [2] to identify each di-

20. See Item 407(e) of Regulation S-K.
§ 5:4.3  PUBLIC COMPANY DESKBOOK

rector who participates in the consideration of executive officer and director compensation.

- **Charter.** As with audit committee and nominating committees, proxy or information statements of U.S. issuers must disclose whether a copy of the compensation committee charter is available on the issuer’s website and, if so, provide the address. Proxy or information statements must include a copy of the charter, if it has been materially amended since the beginning of the last fiscal year or if it is not available on the website and has not been included within three years.

- **Processes and Procedures.** Companies must describe the processes and procedures they employ for the consideration of both executive officer and director compensation. Although this disclosure process may appear similar to the Compensation Discussion and Analysis (CD&A) that U.S. companies are required to include in their proxy statements, the adopting release notes that the disclosure required by this item focuses on the company’s corporate governance structure. In contrast, the CD&A is intended to focus on compensation policies and objectives and to put the quantitative disclosure in context.\(^{21}\)

- **Scope and Authority.** Part of this disclosure must disclose the scope of the authority of the compensation committee and whether any of that authority may be delegated (and to whom it may be delegated). If a different committee considers director compensation, similar disclosure may be required for that committee.

- **Executive Officer Involvement.** Companies must disclose any role played by executive officers in determining the amount and form of executive and director compensation. Such disclosure commonly includes a discussion of recommendations made by chief executive officers and participation of the chief human resources officer in preparing materials for committee consideration.

- **Compensation Committee Interlocks.** Companies must disclose the existence and details of any compensation committee interlocks and of any insider participation in compensation decisions. This disclosure is to be provided under a specific caption in the proxy or information statement.

---

\(^{21}\) See section 13:3 for a discussion of the SEC’s disclosure rules relating to the CD&A.
Highlight Compensation Committee § 5:4.3

Compensation Committee Report. The proxy or information statement must include a Compensation Committee Report consisting of a statement that the compensation committee has reviewed the CD&A with management and has recommended that the CD&A be included in the company’s proxy statement. The Compensation Committee Report is provided over the names of the compensation committee members, but the CD&A itself is not.

The Compensation Committee Report is provided over the names of the compensation committee members and is deemed to be “furnished” with the SEC, unlike the CD&A which is deemed “filed” with the SEC. Therefore, the Compensation Committee Report is subject to a somewhat reduced potential liability regime and is not covered by the CEO and CFO certifications described in chapter 17.

The 2006 revisions also included disclosure as to the role of compensation consultants, which has now been expanded as described in the following section.

[B] Compensation Consultant Disclosure Under 2009 Revisions

[B][1] Background

The SEC finalized a number of additional proxy statement disclosure requirements in December 2009, including an expansion of Item 407[e][3][iii] of Regulation S-K relating to the role of compensation consultants. The revisions were effective February 28, 2010.

[B][2] Discussion of 2009 Revisions

Item 407[e] of Regulation S-K requires disclosure of any role played by compensation consultants in determining or recommending the amount or form of executive and director compensation, the identity of those consultants, whether they are engaged directly by the compensation committee, the nature and scope of their assignment, and the material elements of the instructions or directions given to them. The revised rule included two primary changes regarding disclosure about the activities of compensation consultants and their affiliates.

---

First, the rule provides an exemption from the disclosure requirements where the consultant’s role in determining or recommending executive or director compensation was limited to:

- consulting on any non-discriminatory broad-based plan that is generally available to all salaried employees (such as 401(k) and health insurance plans) in which executives and directors may participate; or
- providing information (such as surveys) that either is not customized for a particular company or that is customized based on parameters that are not developed by the consultant, and about which the consultant does not provide advice.

Second, the revised rule expands the disclosures required when the consulting services include not only a role in determining the amount or form of compensation for executives or directors but also other services to the company by the consultant or its affiliates during the most recently completed fiscal year in excess of $120,000. The required additional disclosure includes:

- the nature and the extent of all additional services provided;
- the aggregate fees for the additional services and the aggregate fees for determining or recommending the amount or form of executive and director compensation;
- if the consultant was engaged by the compensation committee (or persons performing a similar function), whether the decision to engage the compensation consultants or their affiliates for the other services was made, subject to screening, or recommended, by management; and
- if the consultant was engaged by the compensation committee (or persons performing a similar function), whether the compensation committee or the board approved the other services of the compensation consultants or their affiliates.

The rules do not require additional disclosure in situations where both the compensation committee (or persons performing equivalent functions) and management have engaged compensation consultants, so long as the compensation consultant retained by the compensation committee (or persons performing equivalent functions) and its affiliates did not provide additional services in excess of $120,000 during the fiscal year. This exclusion applies even if the compensation consultant retained by management receives in excess of $120,000 of compensation for the other services. The SEC indicates that this exclusion is appropriate since the compensation
committee’s engagement of its own compensation consultant mitigates any potential conflict of interest.\textsuperscript{23}

The SEC stated in the adopting release that it believes that these new disclosures will improve investors’ ability to assess the potential conflicts a consultant may have in advising on executive compensation and noted that the fees generated by such additional services, such as benefits administration, human resources consulting and actuarial services, could, in some cases, exceed the fees earned by the consultant for executive and director compensation services.\textsuperscript{24}

\section*{§ 5:5 Additional Compensation Committee Independence Considerations}

\subsection*{§ 5:5.1 Background}

Both the NYSE and Nasdaq rules require that compensation committees be composed entirely of independent directors. For this purpose, the rules of both exchanges apply the standards for independence that apply to boards of directors generally. Neither the NYSE or Nasdaq rules nor the SEC rules currently impose any additional or heightened independence standards for compensation committee directors.

In light of the actions generally within the purview of compensation committees, however, the independence standards of Rule 16b-3 under the Exchange Act and section 162(m) of the Internal Revenue Code are often relevant to compensation committee members. The standards under these provisions effectively impose two additional layers of independence requirements for compensation committee members.

Each of Rule 16b-3 and section 162(m) provide for favorable treatment for actions taken by independent directors in connection with certain compensation matters. Rule 16b-3 provides an exemption from short-swing profit recovery under section 16 of the Exchange Act for, among other things, transactions between issuers and their directors and officers that are approved by a committee of the board that consists solely of two or more “non-employee directors.” Section 162(m) exempts certain performance-based compensation from the cap on deductibility if a compensation committee composed of two or more “outside directors” determines and certifies the relevant performance goals.

\textsuperscript{23} See id. at text accompanying n.154.
\textsuperscript{24} See id. at paragraph following paragraph referencing n.150.
Although the standards of the three regimes are similar, they are not identical. Moreover, no one of the standards is more restrictive in all cases than the others. As a result, all three of the standards must be considered separately and satisfaction of any one standard does not imply that the other standards will be met. For example, although the outside director standards of section 162(m) are usually viewed as the most restrictive of the various independence requirements, the SEC has noted specifically that the satisfaction of the non-employee director standards under Rule 16b-3 cannot be presumed from satisfaction of the section 162(m) standards.25

§ 5:5.2 Standards for Outside Director Under Section 162(m) of the Code

[A] Text of Requirements

[A][1] Section 162(m) of the Internal Revenue Code

162. Trade or business Expenses

(m) Certain excessive employee remuneration

(1) In general

In the case of any publicly held corporation, no deduction shall be allowed under this chapter for applicable employee remuneration with respect to any covered employee to the extent that the amount of such remuneration for the taxable year with respect to such employee exceeds $1,000,000.

(2) Publicly held corporation

For purposes of this subsection, the term “publicly held corporation” means any corporation issuing any class of common equity securities required to be registered under section 12 of the Securities Exchange Act of 1934.

(3) Covered employee

For purposes of this subsection, the term “covered employee” means any employee of the taxpayer if—

(A) as of the close of the taxable year, such employee is the chief executive officer of the taxpayer or is an individual acting in such a capacity, or

(B) the total compensation of such employee for the taxable year is required to be reported to shareholders under the Securities Exchange Act of 1934 by reason of such employee being among the 4 highest compensated officers for the taxable year (other than the chief executive officer).

(4) Applicable employee remuneration

For purposes of this subsection—

(A) In general

Except as otherwise provided in this paragraph, the term “applicable employee remuneration” means, with respect to any covered employee for any taxable year, the aggregate amount allowable as a deduction under this chapter for such taxable year (determined without regard to this subsection) for remuneration for services performed by such employee (whether or not during the taxable year).

(B) Exception for remuneration payable on commission basis

The term “applicable employee remuneration” shall not include any remuneration payable on a commission basis solely on account of income generated directly by the individual performance of the individual to whom such remuneration is payable.

(C) Other performance-based compensation

The term “applicable employee remuneration” shall not include any remuneration payable solely on account of
§ 5:5.2  
PUBLIC COMPANY DESKBOOK

the attainment of one or more performance goals, but only if—

(i) the performance goals are determined by a compensation committee of the board of directors of the taxpayer which is comprised solely of 2 or more outside directors,

(ii) the material terms under which the remuneration is to be paid, including the performance goals, are disclosed to shareholders and approved by a majority of the vote in a separate shareholder vote before the payment of such remuneration, and

(iii) before any payment of such remuneration, the compensation committee referred to in clause (i) certifies that the performance goals and any other material terms were in fact satisfied.

(D) Exception for existing binding contracts

The term “applicable employee remuneration” shall not include any remuneration payable under a written binding contract which was in effect on February 17, 1993, and which was not modified thereafter in any material respect before such remuneration is paid.

(E) Remuneration

For purposes of this paragraph, the term “remuneration” includes any remuneration (including benefits) in any medium other than cash, but shall not include—

(i) any payment referred to in so much of section 3121 (a)(5) as precedes subparagraph (E) thereof, and

(ii) any benefit provided to or on behalf of an employee if at the time such benefit is provided it is reasonable to believe that the employee will be able to exclude such benefit from gross income under this chapter.

For purposes of clause (i), section 3121 (a)(5) shall be applied without regard to section 3121 (v)(1).
(F) Coordination with disallowed golden parachute payments

The dollar limitation contained in paragraph (1) shall be reduced (but not below zero) by the amount (if any) which would have been included in the applicable employee remuneration of the covered employee for the taxable year but for being disallowed under section 280G.

(G) Coordination with excise tax on specified stock compensation

The dollar limitation contained in paragraph (1) with respect to any covered employee shall be reduced (but not below zero) by the amount of any payment (with respect to such employee) of the tax imposed by section 4985 directly or indirectly by the expatriated corporation (as defined in such section) or by any member of the expanded affiliated group (as defined in such section) which includes such corporation.

[A][2] Treasury Regulation 1.162-27(e)(3)

Sec. 1.162-27 Certain employee remuneration in excess of $1,000,000.

(e) Exception for qualified performance-based compensation—

(1) [*]

(2) [*]

(3) Outside directors

(i) General rule.—The performance goal under which compensation is paid must be established by a compensation committee comprised solely of two or more outside directors. A director is an outside director if the director—

(A) Is not a current employee of the publicly held corporation;

(B) Is not a former employee of the publicly held corporation who receives compensation for prior services (other than benefits under a tax-qualified retirement plan) during the taxable year;
§ 5:5.2  

PUBLIC COMPANY DESKBOOK

(C) Has not been an officer of the publicly held corporation; and

(D) Does not receive remuneration from the publicly held corporation, either directly or indirectly, in any capacity other than as a director. For this purpose, remuneration includes any payment in exchange for goods or services.

(ii) Remuneration received.—For purposes of this paragraph (e)(3), remuneration is received, directly or indirectly, by a director in each of the following circumstances:

(A) If remuneration is paid, directly or indirectly, to the director personally or to an entity in which the director has a beneficial ownership interest of greater than 50 percent. For this purpose, remuneration is considered paid when actually paid (and throughout the remainder of that taxable year of the corporation) and, if earlier, throughout the period when a contract or agreement to pay remuneration is outstanding.

(B) If remuneration, other than de minimis remuneration, was paid by the publicly held corporation in its preceding taxable year to an entity in which the director has a beneficial ownership interest of at least 5 percent but not more than 50 percent. For this purpose, remuneration is considered paid when actually paid or, if earlier, when the publicly held corporation becomes liable to pay it.

(C) If remuneration, other than de minimis remuneration, was paid by the publicly held corporation in its preceding taxable year to an entity by which the director is employed or self-employed other than as a director. For this purpose, remuneration is considered paid when actually paid or, if earlier, when the publicly held corporation becomes liable to pay it.

(iii) De minimis remuneration

(A) In general.—For purposes of paragraphs (e)(3)(ii)(B) and (C) of this section, remuneration that was paid by the publicly held corporation in its preceding taxable year to an entity is de minimis if payments to the entity
did not exceed 5 percent of the gross revenue of the entity for its taxable year ending with or within that preceding taxable year of the publicly held corporation.

(B) Remuneration for personal services and substantial owners.—Notwithstanding paragraph (e)(3)(iii)(A) of this section, remuneration in excess of $60,000 is not de minimis if the remuneration is paid to an entity described in paragraph (e)(3)(ii)(B) of this section, or is paid for personal services to an entity described in paragraph (e)(3)(ii)(C) of this section.

(iv) Remuneration for personal services.—For purposes of paragraph (e)(3)(iii)(B) of this section, remuneration from a publicly held corporation is for personal services if—

(A) The remuneration is paid to an entity for personal or professional services, consisting of legal, accounting, investment banking, and management consulting services (and other similar services that may be specified by the Commissioner in revenue rulings, notices, or other guidance published in the Internal Revenue Bulletin), performed for the publicly held corporation, and the remuneration is not for services that are incidental to the purchase of goods or to the purchase of services that are not personal services; and

(B) The director performs significant services (whether or not as an employee) for the corporation, division, or similar organization (within the entity) that actually provides the services described in paragraph (e)(3)(iv)(A) of this section to the publicly held corporation, or more than 50 percent of the entity’s gross revenues (for the entity’s preceding taxable year) are derived from that corporation, subsidiary, or similar organization.

(v) Entity defined.—For purposes of this paragraph (e)(3), entity means an organization that is a sole proprietorship, trust, estate, partnership, or corporation. The term also includes an affiliated group of corporations as defined in section 1504 (determined without regard to section 1504(b)) and a group of organizations that would be an affiliated group but for the fact that one or more of the organizations are not incorporated. However, the aggregation rules referred to in the preceding sentence do not apply for purposes of determining
whether a director has a beneficial ownership interest of at least 5 percent or greater than 50 percent.

(vi) Employees and former officers.—Whether a director is an employee or a former officer is determined on the basis of the facts at the time that the individual is serving as a director on the compensation committee. Thus, a director is not precluded from being an outside director solely because the director is a former officer of a corporation that previously was an affiliated corporation of the publicly held corporation. For example, a director of a parent corporation of an affiliated group is not precluded from being an outside director solely because that director is a former officer of an affiliated subsidiary that was spun off or liquidated. However, an outside director would no longer be an outside director if a corporation in which the director was previously an officer became an affiliated corporation of the publicly held corporation.

(vii) Officer.—Solely for purposes of this paragraph (e)(3), officer means an administrative executive who is or was in regular and continued service. The term implies continuity of service and excludes those employed for a special and single transaction. An individual who merely has (or had) the title of officer but not the authority of an officer is not considered an officer. The determination of whether an individual is or was an officer is based on all the of facts and circumstances in the particular case, including without limitation the source of the individual's authority, the term for which the individual is elected or appointed, and the nature and extent of the individual's duties.

(viii) Members of affiliated groups.—For purposes of this paragraph (e)(3), the outside directors of the publicly held member of an affiliated group are treated as the outside directors of all members of the affiliated group.

(ix) Examples.—This paragraph (e)(3) may be illustrated by the following examples:

Example 1. Corporations X and Y are members of an affiliated group of corporations as defined in section 1504, until July 1, 1994, when Y is sold to another group. Prior to the sale, A served as an officer of Corporation Y. After July 1, 1994, A is not treated as a former officer of Corporation X by reason of having been an officer of Y.
Example 2. Corporation Z, a calendar-year taxpayer, uses the services of a law firm by which B is employed, but in which B has a less-than-5-percent ownership interest. The law firm reports income on a July 1 to June 30 basis. Corporation Z appoints B to serve on its compensation committee for calendar year 1998 after determining that, in calendar year 1997, it did not become liable to the law firm for remuneration exceeding the lesser of $60,000 or five percent of the law firm’s gross revenue (calculated for the year ending June 30, 1997). On October 1, 1998, Corporation Z becomes liable to pay remuneration of $50,000 to the law firm on June 30, 1999. For the year ending June 30, 1998, the law firm’s gross revenue was less than $1 million. Thus, in calendar year 1999, B is not an outside director. However, B may satisfy the requirements for an outside director in calendar year 2000, if, in calendar year 1999, Corporation Z does not become liable to the law firm for additional remuneration. This is because the remuneration actually paid on June 30, 1999 was considered paid on October 1, 1998 under paragraph (e)(3)(ii)(C) of this section.

Example 3. Corporation Z, a publicly held corporation, purchases goods from Corporation A. D, an executive and less-than-five-percent owner of Corporation A, sits on the board of directors of Corporation Z and on its compensation committee. For 1997, Corporation Z obtains representations to the effect that D is not eligible for any commission for D’s sales to Corporation Z and that, for purposes of determining D’s compensation for 1997, Corporation A’s sales to Corporation Z are not otherwise treated differently than sales to other customers of Corporation A (including its affiliates, if any) or are irrelevant. In addition, Corporation Z has no reason to believe that these representations are inaccurate or that it is otherwise paying remuneration indirectly to D personally. Thus, in 1997, no remuneration is considered paid by Corporation Z indirectly to D personally under paragraph (e)(3)(ii)(A) of this section.

Example 4. (i) Corporation W, a publicly held corporation, purchases goods from Corporation T. C, an executive and less-than-five-percent owner of Corporation T, sits on the board of directors of Corporation W and on its compensation committee. Corporation T develops a new product and agrees on January 1, 1998 to pay C a bonus of $500,000 if Corporation W contracts to purchase the product. Even if
Corporation W purchases the new product, sales to Corporation W will represent less than 5 percent of Corporation T’s gross revenues. In 1999, Corporation W contracts to purchase the new product and, in 2000, C receives the $500,000 bonus from Corporation T. In 1998, 1999, and 2000, Corporation W does not obtain any representations relating to indirect remuneration to C personally (such as the representations described in Example 3).

(ii) Thus, in 1998, 1999, and 2000, remuneration is considered paid by Corporation W indirectly to C personally under paragraph (e)(3)(ii)(A) of this section. Accordingly, in 1998, 1999, and 2000, C is not an outside director of Corporation W. The result would have been the same if Corporation W had obtained appropriate representations but nevertheless had reason to believe that it was paying remuneration indirectly to C personally.

Example 5. Corporation R, a publicly held corporation, purchases utility service from Corporation Q, a public utility. The chief executive officer, and less-than-5-percent owner, of Corporation Q is a director of Corporation R. Corporation R pays Corporation Q more than $60,000 per year for the utility service, but less than 5 percent of Corporation Q’s gross revenues. Because utility services are not personal services, the fees paid are not subject to the $60,000 de minimis rule for remuneration for personal services within the meaning of paragraph (e)(3)(iii)(B) of this section. Thus, the chief executive officer qualifies as an outside director of Corporation R, unless disqualified on some other basis.

Example 6. Corporation A, a publicly held corporation, purchases management consulting services from Division S of Conglomerate P. The chief financial officer of Division S is a director of Corporation A. Corporation A pays more than $60,000 per year for the management consulting services, but less than 5 percent of Conglomerate P’s gross revenues. Because management consulting services are personal services within the meaning of paragraph (e)(3)(iv)(A) of this section, and the chief financial officer performs significant services for Division S, the fees paid are subject to the $60,000 de minimis rule as remuneration for personal services. Thus, the chief financial officer does not qualify as an outside director of Corporation A.
Example 7. The facts are the same as in Example 6, except that the chief executive officer, and less-than-5-percent owner, of the parent company of Conglomerate P is a director of Corporation A and does not perform significant services for Division S. If the gross revenues of Division S do not constitute more than 50 percent of the gross revenues of Conglomerate P for P's preceding taxable year, the chief executive officer will qualify as an outside director of Corporation A, unless disqualified on some other basis.

[B] Discussion of the Rule

Section 162(m) of the Internal Revenue Code (the “Code”) generally disallows deductions by public companies for compensation to “covered employees” (the chief executive officer and the next three highest compensated officers other than the chief executive officer and the chief financial officer) in excess of one million dollars in any taxable year of the company. However, awards of performance-based compensation will be deductible if, among other things, the performance goals are pre-approved by a compensation committee consisting solely of two or more “outside directors.”

Under the statutory definition of “performance-based compensation” under section 162(m) of the Code, to qualify as performance-based, compensation must:

- be based on performance goals that are pre-established by the compensation committee made up of exclusively two or more “outside directors,”
- be made pursuant to a plan that is disclosed and approved by shareholders as to the material terms for payments, including performance criteria before such payment is made, and
- be certified before payment by the committee as being payable based on such material terms including achievement of performance goals.

Unlike Rule 16b-3, the requirements of section 162(m) of the Code cannot be otherwise satisfied by substituting the full board of

26. See IRS Notice 2007-49, which changed the group of executive officers who are “covered employees” under section 162(m) from the CEO and the next four most highly compensated officers to the CEO and the next three most highly compensated officers (other than the CEO and the CFO). This notice was issued after the SEC amended the proxy disclosure rules to include the CFO as a named executive officer, regardless of compensation.

27. See section 162(m)(5), which limits the deduction to $500,000 for certain TARP recipients.
§ 5:5.2 PUBLIC COMPANY DESKBOOK

directors for a committee of outside directors (unless all directors who do not qualify as “outside directors” abstain from the vote).

[B][1] Requirements to Be an Outside Director

Under section 162(m), the director is an “outside director” if she:

- is not a current employee of the public company,
- is not a former employee of the public company who received compensation for prior services in the current fiscal year (other than tax-qualified retirement plan benefits),
- is not a former officer of the public company, and
- does not receive remuneration, either directly or indirectly, from the public company in any capacity other than as a director.

The first two requirements are straightforward and generally overlap with other independence requirements. The last two requirements, however, often require additional evaluation.

[B][2] Former Officer

In many cases, prior service as an “officer” of the company will preclude a director from ever being considered an outside director under section 162(m). Section 1.162-27(e)(3)(vii) of the Treasury Regulations contains the definition of “officer” and provides that a determination must be based on “all the of facts and circumstances in the particular case, including without limitation the source of the individual’s authority, the term for which the individual is elected or appointed, and the nature and extent of the individual’s duties.”

Because the bar on former officers is indefinite, there have been a number of interpretative issues raised. Some of the significant ones include:

- Interim Chief Executive Officer. In a Revenue Ruling in 2008, the IRS found that a director who served as an interim chief executive officer of the public company may not qualify as an outside director. In this determination, the IRS considered the nature and extent of the director’s duties while serving as the interim chief executive officer and whether these duties were regular and continued during the interim period or for a special purpose or single transaction only.²⁸

- Spin-offs or Other Corporate Separations. Section 1.162-27(e)(3)(vi) of the Treasury Regulations provides that a director will not be disqualified from serving as an outside director

solely because the director is a former officer of a previously affiliated corporation of the publicly held company.

- **Service Before the Company Becomes Public.** In a Private Letter Ruling in 2005, the IRS found that a director is not precluded from being an outside director solely because he was a senior partner of a partnership that converted into the public corporation where the director is not and has never been employed by the public company and does not receive any compensation from the company for his prior services to the partnership (other than benefits under tax-qualified retirement plans that were accrued during his service with the partnership).²⁹

[B][3] Remuneration Received from the Company

Section 1.162-27(e)(3)(i) of the Treasury Regulations disqualifies any director who receives remuneration from the publicly held corporation, either directly or indirectly, in any capacity other than as a director. For this purpose, remuneration includes any payment in exchange for goods or services.

Section 1.162-27(e)(3)(ii) of the Treasury Regulations describes when a director will be considered to receive remuneration directly or indirectly and provides that a director will not qualify as an outside director where:

- remuneration is paid,³⁰ to the director personally or to an entity in which the director has a 50% or greater beneficial ownership,
- non-de minimis remuneration was paid³¹ by the company in the prior tax year to an entity in which the director has a 5% to 50% beneficial ownership, or
- non-de minimis remuneration was paid by the company in the prior taxable year to an entity by which the director is employed or self-employed other than as a director.

Under section 1.162-27(e)(3)(ii), remuneration paid by a publicly held corporation can be de minimis if the payments do not exceed

---

29. See Priv. Ltr. Rul. 200546012 [Nov. 18, 2005].
30. For this prong of the standard, remuneration is considered paid when actually paid [and throughout the remainder of that taxable year of the corporation] and, if earlier, throughout the period when a contract or arrangement to pay remuneration is outstanding. See Treas. Reg. § 1.162-27(e)(3)(ii)(A).
31. For this prong of the standard, remuneration is considered paid when actually paid or, if earlier, when the publicly held company becomes liable to pay it. See Treas. Reg. § 1.162-27(e)(3)(ii)(B).
5% of the gross revenue of the receiving entity. However, this definition of de minimis only applies for the third prong and only if the remuneration is not for “personal or professional services.” For the second prong and for the third prong, if the remuneration is for personal or profession services, any remuneration above $60,000 will be considered non-de minimis.

Remuneration for personal or professional services includes, among other things, legal, accounting, investment banking and management consulting services performed for the company.\(^\text{32}\) However, remuneration is only treated as being for personal or professional services if either (1) the relevant director performs significant services (whether or not as an employee) for the division or similar organization (within the receiving entity) that actually provides the services for the public company, or (2) more than 50% of the receiving entity’s gross revenues are derived from the division or similar organization.

IRS guidance in this area is limited and can turn on very technical distinctions. In one Private Letter Ruling, the IRS found that a director will qualify as an outside director where the director did not receive compensation directly or indirectly from the public company or its subsidiary but rather from a third-party landlord of a subsidiary who paid a commission to a real estate brokerage firm indirectly owned and controlled by the director.\(^\text{33}\) In a separate Private Letter Ruling, the IRS found that the receipt of legal fees by a law firm at which the director is a partner will not cause the director to fail to qualify as an outside director where the law firm provides legal services to a trade association and a wholly owned subsidiary of the public company is a member of the trade association.\(^\text{34}\)

---

33. See Priv. Ltr. Rul. 200618020 [Mar. 4, 2006] (on these facts, the IRS found that the arrangement among the subsidiary, landlord, management company and broker did not establish facts under which the director was considered to receive indirect remuneration under Treas. Reg. § 1.162(c)(3)(i)(D)).
34. See Priv. Ltr. Rul. 200647010 [Nov. 24, 2006] (on these facts, the director’s partnership interest in the law firm represented less than a 5% interest in the partnership, the director was not the engagement partner nor the primary attorney for the trade association and the director’s compensation as a partner had no direct relationship to the amount of money received by the law firm from the trade association).
§ 5:5.3 Standards for Non-Employee Director Under Section 16 of the Exchange Act

[A] Text of Requirements

[A][1] Text of Section 16(b) of the Exchange Act

(b) Profits from Purchase and Sale of Security Within Six Months. For the purpose of preventing the unfair use of information which may have been obtained by such beneficial owner, director, or officer by reason of his relationship to the issuer, any profit realized by him from any purchase and sale, or any sale and purchase, of any equity security of such issuer (other than an exempted security) or a security-based swap agreement (as defined in section 206B of the Gramm-Leach-Bliley Act) involving any such equity security within any period of less than six months, unless such security or security-based swap agreement was acquired in good faith in connection with a debt previously contracted, shall inure to and be recoverable by the issuer, irrespective of any intention on the part of such beneficial owner, director, or officer in entering into such transaction of holding the security or security-based swap agreement purchased or of not repurchasing the security or security-based swap agreement sold for a period exceeding six months. Suit to recover such profit may be instituted at law or in equity in any court of competent jurisdiction by the issuer, or by the owner of any security of the issuer in the name and in behalf of the issuer if the issuer shall fail or refuse to bring such suit within sixty days after request or shall fail diligently to prosecute the same thereafter; but no such suit shall be brought more than two years after the date such profit was realized. This subsection shall not be construed to cover any transaction where such beneficial owner was not such both at the time of the purchase and sale, or the sale and purchase, of the security or security based swap agreement (as defined in section 206B of the Gramm-Leach-Bliley Act) involved, or any transaction or transactions which the Commission by rules and regulations may exempt as not comprehended within the purpose of this subsection.

[A][2] Text of Rule 16b-3

Rule 16b-3—Transactions Between an Issuer and Its Officers or Directors

(a) General. A transaction between the issuer (including an employee benefit plan sponsored by the issuer) and an officer or
§ 5:5.3    PUBLIC COMPANY DESKBOOK

director of the issuer that involves issuer equity securities shall be exempt from Section 16(b) of the Act if the transaction satisfies the applicable conditions set forth in this section.

(b) Definitions.

* * *

(3)(i) A Non-Employee Director shall mean a director who:

(A) Is not currently an officer (as defined in Rule 16a-1(f)) of the issuer or a parent or subsidiary of the issuer, or otherwise currently employed by the issuer or a parent or subsidiary of the issuer;

(B) Does not receive compensation, either directly or indirectly, from the issuer or a parent or subsidiary of the issuer, for services rendered as a consultant or in any capacity other than as a director, except for an amount that does not exceed the dollar amount for which disclosure would be required pursuant to Item 404(a) of Regulation S-K; and

(C) Does not possess an interest in any other transaction for which disclosure would be required pursuant to Item 404(a) of Regulation S-K.

(iii) Notwithstanding paragraph (b)(3)(i) of this section, a Non-Employee Director of a closed-end investment company shall mean a director who is not an “interested person” of the issuer, as that term is defined in Section 2(a)(19) of the Investment Company Act of 1940.

[B] Discussion of the Rule

Section 16(b) of the Exchange Act authorizes a public company to recover any profit realized by insiders [officers, directors and 10% shareholders] from any purchase and sale [or sale and purchase] of any equity security of the public company within any six-month period—otherwise known as “short-swing transactions.” Section 16(b) seeks to prevent such insiders from using confidential corporate information for personal gain.35

35. Section 16(b) is a strict liability test and does not require that the insider actually know of material non-public information about the company. See, e.g., Foremost-McKesson, Inc. v. Provident Sec. Co., 423 U.S. 232, 251 [1976].
Compensation Committee § 5:5.3

The SEC adopted Rule 16b-3 to exempt a wide variety of transactions that do not present opportunities for abuse of insider information between a public company and its officers and directors. Accordingly, Rule 16b-3 exempts transactions involving a grant, award or other acquisition from the public company (other than a discretionary transaction), whether or not intended for a compensatory or other particular purpose, provided one of the following criteria is met:

- the awards are subject to a six-month holding period (from date of grant);
- the awards were ratified by the shareholders;
- the awards were pre-approved by the full board of directors; or
- the awards were approved by a committee of the board composed solely of two or more “non-employee directors.”

For awards that are not subject to a six-month holding period requirement, it is generally not practical to have the awards ratified by the shareholders or pre-approved by the entire board of directors. Therefore, most public companies grant awards that are exempt from short-swing profits by having the awards approved by a committee of the board composed solely of two or more “non-employee directors.”

“Non-employee director” is defined in Rule 16b-3(b)(3), which provides that a “non-employee director” is a director who:

- is not currently an officer of, or otherwise employed by, the company (or of a parent or subsidiary),

36. See Exchange Act Rule 16b-3 [17 C.F.R. § 240.16b-3].
37. See Rule 16b-3(b)(1) [a “Discretionary Transaction” is an employee benefit plan transaction that is at the volition of a plan participant and results in either an intra-plan transfer involving an issuer equity securities fund, or a cash distribution funded by a volitional disposition of an issuer equity security. However, this definition excludes transactions made in connection with the participant’s death, disability, retirement or termination of employment, or as required pursuant to a provision of the Internal Revenue Code. A Discretionary Transaction is exempted by Rule 16b-3 only if it satisfies the conditions of Rule 16b-3(f)].
38. Following Levy v. Sterling Holding Co., 314 F.3d 106 [3d Cir. 2002], the SEC revised Rule 16b-3(d) to make clear that any acquisition from the issuer, other than a discretionary transaction, including without limitation an award or grant, whether or not intended for a compensatory or other particular purpose, is exempt if the other conditions of the rule are satisfied. See Ownership Reports and Trading by Officers, Directors and Principal Security Holders, Rel. Nos. 33-8600, 34-52202, and IC-27025 [Aug. 3, 2005], 70 Fed. Reg. 46,080 [Aug. 9, 2005], available at www.sec.gov/rules/final/33-8600.pdf.
§ 5:6  Proposed Legislation to Heighten Independence Standards

There have been a number of initiatives in 2009 to increase the independence and accountability of compensation committee members. On July 31, 2009, the House of Representatives passed the Corporate and Financial Institution Compensation Fairness Act of 2009 (the “Fairness Act”), which, among other things, would require additional independence standards for public company compensation committees. As of September 1, 2009, the Fairness Act

---

40. For the purposes of Rule 16b-3(b)(3)(ii)(A), “subsidiary” is defined pursuant to Rule 12b-2, as an affiliate controlled directly or indirectly through one or more intermediaries. See Section 16 Interpretations, supra note 25, at Question 123.09.

41. As of September 2009, $120,000 is the dollar amount for which disclosure would be required pursuant to Item 404(a) of Regulation S-K. See Item 404(a) of Reg. S-K.

42. The requirements of Item 404(a) are discussed in detail in section 8:2. In addition, a director will not be disqualified from being a non-employee director merely as a consequence of disclosure regarding loans by a bank, savings and loan association, or broker-dealer contemplated by Instruction 4.c to Item 404(a) [loan made in ordinary course of business, on substantially same terms as for unrelated persons, no more than normal risk of collectability, etc.]. Section 16 Interpretations, supra note 25, at Question 123.19.

43. See Section 16 Interpretations, supra note 25, at Question 123.08.

had been referred to the Senate Committee on Banking, Housing, and Urban Affairs.

The Fairness Act would apply to all public companies and would require heightened independence standards on compensation committees, similar to those standards required by SOA section 301 on audit committees. 45 No later than nine months after the enactment of the bill, the SEC would be required to publish rules prohibiting the listing of equity securities of any issuer unless the following five criteria are met:

1. The compensation committee must have the authority to retain an independent compensation consultant and be directly responsible for the appointment, compensation, and oversight of the work of the independent consultant.

2. Proxies or consent solicitations must disclose whether an independent compensation consultant was retained, and if not, then the compensation committee’s rationale for not hiring such an independent consultant. 46

3. The compensation committee must also have the authority to retain independent counsel and other advisers meeting independence standards to be prescribed by the SEC.

4. Each issuer must provide the compensation committee with appropriate funding (as determined by the committee) to pay these independent advisers.

5. Any compensation consultant or other similar adviser to the compensation committee will also be held to heightened independence standards to be set by the SEC.

Each member of the compensation committee must be independent, which requires that the member not receive, other than as a board or committee member, any consulting, advisory or other compensatory fee from the issuer. The SEC is granted authority to exempt relationships “where appropriate in view of the purposes of this section.” The proposed legislation also includes an advisory vote for shareholders on compensation at each annual meeting and in connection with every change-in-control transaction.

It is unclear whether the enactment of the Dodd-Frank Act in July 2010 will have any impact on the status of this proposed legislation.

45. See sections 4:2 and 4:3.
46. This requirement would apply to any proxy or consent solicitation occurring on or after the first anniversary of the enactment of the Fairness Act. See the Fairness Act, supra note 44.