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Client Alert

A report for clients and friends of the firm

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NYSE and Nasdaq Corporate Governance Rules Impact Composition of Compensation Committees

The Securities and Exchange Commission (the "SEC") recently approved corporate governance rules submitted by both the New York Stock Exchange ("NYSE") and the Nasdaq Stock Market, Inc. ("Nasdaq"). Among other significant changes, both the NYSE rules and Nasdaq rules provide that "independent directors" must comprise a majority of the board of directors of every listed company (with some limited exceptions).

In addition, the NYSE rules specifically require all NYSE-listed companies to maintain a compensation committee comprised entirely of "independent directors." Although the Nasdaq rules do not require listed companies to maintain compensation committees to determine executive compensation, such companies generally must either: (i) determine (or recommend to the board for determination) chief executive and other executive officer compensation through a committee comprised solely of "independent directors;"[1] or (ii) determine (or recommend to the board for determination) chief executive and other executive officer compensation by a vote of a majority of the "independent" directors.

The NYSE and Nasdaq independent director rules will take effect with a company's first annual meeting occurring after January 15, 2004, but no later than October 31, 2004, with the following exceptions:

- a company with a classified board that would be required to change a director who would not normally stand for election prior to such annual meeting is allowed to keep such director in office until the second annual meeting after such date, but no later than December 31, 2005;[2]
- a company having its initial public offering on NYSE or Nasdaq must have one independent member at the time of listing, a majority of independent members within ninety days of listing, and fully independent committees within one year;
- a company listing on NYSE or Nasdaq upon the transfer from another market would have 12 months from the date of transfer in which to comply with this requirement, to the extent the market on which they were listed did not have the same requirement; and
- a company transferring from another market that has substantially similar independent director requirements will be afforded the balance of any grace period afforded by that market.

New Rules Compared to Other Director Requirements

Currently, most compensation committees of public companies include at least two directors that are considered "outside directors" for purposes of Section 162(m) of the Internal Revenue Code of 1986, as amended (the "Code") and "non-employee directors" under Rule 16b-3 of the Securities Exchange Act of 1934 (the "Exchange Act"). Although the NYSE and Nasdaq "independent director" definitions are similar to the "outside" and "non-employee" directors definitions, there are significant differences. Accordingly, companies listed on the NYSE or Nasdaq should review compensation committee composition in advance of the effective dates described above.

The requirements for "independence" under the NYSE and Nasdaq rules, for "outside director" under Code Section 162(m) and "non-employee" director under Rule 16b-3 are summarized below. We have also attached to the end of this Client Alert a table comparing the current requirements for director "independence" under Section 162(m) of the Code, Rule 16b-3 of the Exchange Act, and the Nasdaq and NYSE rules.

Director Independence under NYSE and Nasdaq Rules

NYSE

Definition of Independent Director

NYSE requires that a listed company's board of directors affirmatively determine, based on all facts and circumstances, that each independent director has no material relationship with the company either directly or as a partner, shareholder or officer of an organization that has a relationship with the company (including any parent or subsidiary). The company must publicly disclose this determination in its annual proxy statement or if the company does not file a proxy statement on Form 10-K.

Conflicted Relationships

A director is conclusively presumed to lack independence if, currently, or during a look-back period, he or she:

- is an employee (other than as an interim Chairman or CEO), or his or her immediate family member[3] is an executive officer, of the listed company;
- receives, or his or her immediate family member receives, more than $100,000 per year in direct compensation from the listed company, other than (i) director and committee fees; (ii) pension or other forms of deferred compensation for prior service (provided such compensation is not contingent in any way on continued service); (iii) compensation received by a director for former service as an interim Chairman or CEO; or (iv) compensation received by an immediate family member for service as a non-executive employee of the listed company;
- is affiliated with or employed by, or his or her immediate family member is affiliated with or employed in a professional capacity by, a present or former internal or external auditor of the listed company;
- is employed, or his or her immediate family member is employed as an executive officer of another company where any of the listed company's present executives serve on that company's compensation committee; or
- is an executive officer or an employee, or his or her immediate family member is an executive officer, of a company that makes payments to, or receives payments from, the listed company for property or services in an amount which, in any single fiscal year, exceeds the greater of $1 million or 2% of such other company's gross revenues.[4]

Look-Back Periods

- *Prior to November 4, 2004*. A one-year look-back period applies after the termination of the offending relationship or status for the disqualifying circumstances described above.[5]
- *After November 4, 2004*. A three-year look-back period applies after the termination of the offending relationship or status for the disqualifying circumstance described above.

Nasdaq

Definition of Independent Director

Nasdaq defines "independent director" as a person other than an officer or employee of the company or its subsidiaries or any other individual having a relationship, which in the opinion of the company's board of directors, would interfere with the exercise of independent judgment in carrying out the responsibilities of a director.

Conflicted Relationships

A director is conclusively presumed to lack independence if, currently or during a look-back period, he or she:[6]

- is employed by the company or by any parent or subsidiary of the company;[7]
- has accepted[8] or has a family member[9] who accepted any payments from the company or any parent or subsidiary of the company in excess of $60,000 other than (i) compensation for board or board committee service, (ii) payments arising solely from investments in the company's securities, (iii) compensation paid to a family member who is a non-executive employee of the company or a parent or subsidiary of the company, (iv) benefits under a tax-qualified retirement plan or non-discretionary compensation or (v) loans permitted under Section 13(k) of the Exchange Act;
- is a family member of an individual who is employed by the company or by any parent or subsidiary of the company as an executive officer;
- is or has a family member who is, a partner in, or a controlling shareholder or an executive officer of any organization to which the company made, or from which the company received, payments for property or services that exceed the greater of 5% of the recipient's consolidated gross revenues for that year, or $200,000, other than (i) payments arising solely from investments in the company's securities or (ii) payments under non-discretionary charitable contribution matching programs;

- is, or has a family member who is, employed as an executive officer of another entity where any of the executive officers of the listed company serve on the compensation committee of such other entity; or

- is, or has a family member who is, a current partner of the company's outside auditor, or was a partner or employee of the company's outside auditor who worked on the company's audit.

Look-Back Period

The disqualifying circumstances described above are subject to a three-year look-back period that commences on the date the relationship ceases. For example, a director employed by the company is not independent until three years after such employment terminates.

Summary of Other Factors Affecting Compensation Committee Structure

The 162(m) and 16b-3 director "independence" rules are summarized below. The attached chart provides additional detail on the operation of these rules.

Section 162(m) of the Internal Revenue Code

Under Section 162(m) of the Code, a publicly-held corporation[10] is not allowed to deduct compensation in excess of $1 million paid to its chief executive officer or any of its other four most highly paid officers listed in such company's proxy statement in a taxable year unless it is qualified "performance-based compensation." In order for compensation to qualify as performance-based, the performance goals under which compensation is payable must be established by the corporation's compensation committee within certain specified time periods, and, to the extent applicable, grants and awards of stock options, stock appreciation rights, restricted stock and other stock-based compensation must be made by the compensation committee. In addition, the compensation committee must certify in writing the attainment of the relevant performance goals and any other material terms prior to the payment of compensation, except in the case where the compensation amount is solely attributable to an increase in stock price (e.g., stock options or stock appreciation rights).

The compensation committee must be comprised solely of two or more "outside" directors to qualify for this exception. In order to qualify as an "outside" director, a director:

- cannot be a current employee of the publicly-held corporation;

- cannot be a former employee of the publicly-held corporation who receives compensation for prior services during the taxable year (other than benefits under a tax-qualified retirement plan);

- cannot be a current or former officer of the publicly-held corporation; and

- cannot receive remuneration (as defined in Code Section 162(m)) from the publicly-held corporation, either directly or indirectly, in any capacity other than as a director.

Rule 16b-3 of the Securities and Exchange Act

Rule 16b-3 of the Exchange Act exempts grants of stock option and stock awards to executive officers and directors from short-swing trading liability under Section 16 of the Exchange Act if a committee of the board of directors composed solely of two or more "non-employee" directors approves the grant or award. In order to qualify as a "non-employee" director, a director generally cannot be a current officer or employee of the company or a parent or subsidiary of the company and since the beginning of the company's last fiscal year the director:

- cannot receive compensation in excess of $60,000, either directly or indirectly, from the company or a parent or subsidiary of the company, for services rendered as a consultant or in any capacity other than as a director;

- cannot possess an interest in any related party transactions where the amount involved exceeds $60,000; and

- cannot engage in a business relationship for which disclosure would be required pursuant to Item 404(b) of Regulation S-K.[11]

Conclusion

Listed companies should review their existing compensation and other board committee composition to ensure compliance with exchange, tax and securities law rules. Although the various director "independence" rules are similar, it is possible that a director could be "independent" under one rule but not the other.

COMPARISON OF CERTAIN PROVISIONS UNDER THE NYSE AND NASDAQ RULES

	Outside Directors Under Section 162(m)	Non-Employee Directors Under Rule 16b-3	Independent Directors Under NYSE Section 303A	Independent Directors Under Nasdaq Rule 4200
Current Employee or Officer	• Cannot be a current employee of the publicly-held corporation. • Cannot be a current officer of the corporation.	• Cannot be a current officer (as defined in Rule 16a-1(f)) or otherwise employed by the company or a parent or subsidiary of the company.	• Cannot be an employee (other than as an interim Chairman or CEO), or have an immediate family member who is an executive officer, of the listed company.	• Cannot be an employee of the company or any parent or subsidiary of the company.
Former Employee or Officer	• Cannot be a former employee of the corporation who receives compensation for prior services during the taxable year (other than benefits under a tax-qualified retirement plan). • Cannot be a former officer of the corporation.		• Cannot be a former employee (other than as an interim Chairman or CEO), or have an immediate family member who was an executive officer, of the listed company during the look-back period.[a]	• Cannot be a former employee of the company or any parent or subsidiary of the company during the look-back period.[b]
Remuneration Received	• Cannot receive remuneration[c] from the corporation, either directly or indirectly, in any capacity other than as a director.	• Since the beginning of the company's last fiscal year, cannot receive compensation in excess of $60,000, either directly or indirectly, from the company or a parent or subsidiary of the company, for services rendered as a consultant or in any capacity other than as a director.	• Cannot receive or have an immediate family member who receives, more than $100,000 per year in direct compensation from the listed company during the look-back period.[d] • Cannot be an executive officer or an employee, or have an immediate family member who is an executive officer, of a company that makes payments to, or receives payments from, the listed company for property or services in an amount which, in any single fiscal year, exceeds the greater of $1 million or 2% of such other company's gross revenues during the look-back period.	• Cannot accept or have a family member who has accepted any payments from the company or any parent or subsidiary of the company in excess of $60,000 during the look-back period.[e] • Cannot be or have a family member who is, a partner in, or a controlling shareholder or an executive officer of any organization to which the company made, or from which the company received, payments for property or services that exceed the greater of 5% of the recipient's consolidated gross revenues for that year, or $200,000 during the look-back period.[f]
Conflicted Relationships		• Since the beginning of the company's last fiscal year, cannot possess an interest in any related party transactions where the amount involved exceeds $60,000. • Since the beginning of the company's last fiscal year, cannot engage in a business relationship for which disclosure would be required pursuant to Item 404(b) of Regulation S-K.	• Cannot be or have an immediate family member who is affiliated with or employed by, or whose immediate family member is affiliated with or employed in a professional capacity by, a present or former internal or external auditor of the listed company during the look-back period. • Cannot be or have an immediate family member who is employed as an executive officer of another company where any of the listed company's present executives serve on that company's compensation committee during the look-back period.	• Cannot be a family member of an individual who is employed by the company or by any parent or subsidiary of the company as an executive officer. • Cannot be or have a family member who is employed as an executive officer of another entity where any of the executive officers of the listed company serve on the compensation committee of such other entity during the look-back period. • Cannot be or have a family member who is a current partner of the company's outside auditor, or was a partner or employee of the company's outside auditor who worked on the company's audit during the look-back period.

Notes to Chart

[a] Prior to November 4, 2004 a one-year look-back period applies after the termination of the offending relationship, and a three-year look-back period applies thereafter.

[b] These disqualifying circumstances are subject to a three-year look-back period that commences on the date the relationship ceases.

[c] Remuneration includes any payments in exchange for goods or services and is deemed to be received, directly or indirectly, by a director if: (i) paid, directly or indirectly, to the director or to an entity (any organization that is a sole proprietorship, trust, estate, partnership (including limited liability company) or corporation) in which the director has a beneficial ownership interest of greater than 50%; (ii) 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% but not more than 50%; and (iii) 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. *De minimis* remuneration is measured based on the amount paid by the publicly-held corporation in its preceding taxable year and may not exceed 5% of the gross revenue of the entity for the entity's taxable year ending with or within the publicly-held corporation's preceding taxable year. Remuneration in excess of $60,000, even if less than 5% of gross revenue, is not *de minimis* if the remuneration is paid to an entity in which the director has a beneficial ownership interest of at least 5% but not more than 50%, or is paid for personal services (as defined in the applicable Treasury regulations) to an entity by which the director is employed or self-employed other than as a director.

[d] Other than (i) director and committee fees; (ii) pension or other forms of deferred compensation for prior service (provided such compensation is not contingent in any way on continued service); (iii) compensation received by a director for former service as an interim Chairman or CEO; or (iv) compensation received by an immediate family member for service as a non-executive employee of the listed company.

[e] Other than (i) compensation for board or board committee service; (ii) payments arising solely from investments in the company's securities; (iii) compensation paid to a family member who is a non-executive employee of the company or a parent or subsidiary of the company; (iv) benefits under a tax-qualified retirement plan or non-discretionary compensation; or (v) loans permitted under Section 13(k) of the Exchange Act.

[f] Other than (i) payments arising solely from investments in the company's securities or (ii) payments under non-discretionary charitable contribution matching programs.

Endnotes:

1 If the committee has at least three members, the Nasdaq rules permit one non-independent director, who is not a current officer or employee, or family member of a current officer or employee, to serve on the compensation committee for no more than two years, provided that (i) the board, under exceptional and limited circumstances, determines that the inclusion of such director on the compensation committee is required by the best interests of the company and its shareholders and (ii) the board publicly discloses in the next annual meeting proxy statement the use of such exception, the nature of the individual's relationship to the company and the reasons for the board's determination.

2 The NYSE has recently indicated in an answer to a Frequently Asked Question, published on January 29, 2004, that if such a company is able to comply with these requirements by the earlier date of its annual meeting and October 31, 2004, by replacing any non-independent directors who would normally stand for election at its 2004 annual meeting, it must comply by such earlier date.

3 NYSE defines an "immediate family member" as an individual's spouse, parents, children, siblings, mother-in-law and father-in-law and sons and daughters-in-law and anyone (other than domestic employees) who shares such person's home. A listed company need not consider individuals who are no longer immediate family members as a result of legal separation or divorce or those who have died or become incapacitated.

4 Charitable organizations are not considered companies for these purposes. A listed company must disclose in its public filings any charitable contributions made to any charitable organization in which a director serves as an executive officer if, within the look-back period, contributions in any single fiscal year exceeded the greater of $1 million or 2% of such charitable organization's consolidated gross revenues in any single fiscal year within the preceding three years.

5 The look-back period for the last test described above applies solely to the financial relationship between the listed company and the director or the immediate family member's current employer; a listed company need not consider former employment of the director or immediate family member.

6 In lieu of the rules described below, in the case of an investment company, a director who is an "interested person" as defined in Section 2(a)(19) of the Investment Company Act of 1940, other than in his or her capacity as a member of the board of directors or any board committee, will be unable to qualify as an independent director.

7 Nasdaq has indicated that it will only look to the parent and those subsidiaries that are controlled by and consolidated with the company's financial statements when determining director independence.

8 Includes payments made directly to or for the benefit of the director or a family member of the director. Nasdaq has indicated that consulting or personal services contracts with a director or family member of a director or political contributions to the campaign of a director or a family member of the director would be considered under this rule.

9 Nasdaq defines "family member" as a person's spouse, parents, children, and siblings, whether by blood, marriage (including in-laws) or adoption, or anyone residing in such person's home.

10 A publicly-held corporation means a corporation issuing any class of common equity securities required to be registered under Section 12 of the Exchange Act. Whether a corporation is publicly-held is determined based solely on whether, as of the last day of its taxable year, the corporation is subject to the reporting obligations of Section 12 of the Exchange Act. A publicly-held corporation also includes an affiliated group of corporations, as defined in Section 1504 of the Code. However, an affiliated group of corporations does not include any subsidiary that is itself a publicly-held corporation.

11 Item 404(b) of Regulation S-K generally requires registration statement and proxy disclosure of business relationships with a registrant where the amount involved exceeds greater than 5 % of the consolidated gross revenue of either the registrant or the other entity.

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