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Compensation Committee and Advisor Independence Standards: Actions to Take Now

A Word from the Publisher

In this issue, Mark Borges of Compensia helps us take an in-depth look at the NYSE and Nasdaq's new listing standards on the independence of compensation committees and their advisors.

On pg 2, we discuss actions to take now to ensure that compensation committee members meet the new standards for independence. We move on to the topic of compensation committee advisors on pg 3, providing specific action items to take with respect to compensation consultants and legal advisors. We also suggest changes to make to the compensation committee charter on pg 5.

On pg 6, we examine the disclosures companies should be making with respect to any compensation consultant conflicts of interest and include several sample disclosures.

Lastly, on pg 11, we have a short item about regulations the IRS recently issued implementing the final phase of cost-basis reporting on Form 1099-B. We are disappointed to note that the basis reported for sales of shares acquired under employee stock options and ESPPs will still be incorrect in most cases. Moreover, there won't be any indication on the form to alert executives to this fact.

We are already eagerly anticipating the "10th Annual Proxy Disclosure and Executive Compensation Conferences" along with the "21st Annual NASPP Conference," which will be held from September 23-26 in Washington DC. In keeping with our lead article in this issue, one key session at the Conferences will be "Compensation Committees & Advisors: The NYSE & Nasdaq Speak," featuring representatives from both the NYSE and Nasdaq discussing these new requirements. And that is just one of many sessions we are looking forward to attending. We urge all of our readers to register for these critical Conferences today—don't wait; the early-bird rate is only available through May 10.

—J.M.B.

Acting Now: How to Deal With the New Compensation Committee & Committee Advisor Independence Requirements

In January, the SEC took another step in its inexorable march to complete the rulemaking needed to fully implement the corporate governance and executive compensation provisions of the Dodd-Frank Act. (Given that Dodd-Frank was signed into law in June 2010—over 34 months ago—it may be worth a moment to recall that Subtitle E of Title IX of the Dodd-Frank Act, the so-called "Investor Protection and Securities Reform Act of 2010," contained seven separate governance and compensation-related provisions).

On January 11, the SEC approved changes to the listing standards of the New York Stock Exchange, the Nasdaq Stock Market, and the other national securities exchanges which impose specific requirements concerning the independence of board compensation committees, the scope of such committee's authority to engage, oversee, and compensate such advisers, and the assessment of the independence of such advisers (see, for example, Exchange Act Release 68639 (NYSE) (Jan. 11, 2013); Exchange Act Rel. 68640 (Nasdaq) (Jan. 11, 2013)). This rulemaking joins Section 951, the shareholder vote on executive compensation disclosures (commonly referred to as "Say-on-Pay"), and Section 957, which restricts broker voting of uninstructed shares on executive compensation matters, as the third corporate governance or executive compensation-related provision of Dodd-Frank to become effective.

What's Covered by the New Requirements

Section 952, which added new Section 10C to the Securities Exchange Act of 1934, covers four specific subjects:

- Independence of the board compensation committee;



- 2** – Assessing the independence of the advisers to the board compensation committee;
- Scope of responsibilities and authority of the board compensation committee; and
 - Disclosure of any conflicts of interest arising from the work of compensation consultants that provide advice or recommendations on the amount or form of executive and director compensation.

In June 2012, the SEC adopted Exchange Act Rule 10C-1 to facilitate the implementation of the new requirements through the listing standards of the national securities exchanges (see Securities Act Rel. 9330 (Jun. 20, 2012)).

While the new requirements will have their greatest impact on the composition and operation of board compensation committees, they also will affect a company's corporate governance and executive compensation disclosures in its Exchange Act reports (including its proxy and information statements). These new requirements are likely to lead to more robust disclosure about the board compensation committee and its role in the compensation-setting process, as well as enabling investors to better assess the objectivity and impartiality of the advice that the committee receives from its principal advisors.

When the New Requirements Take Effect

Most of the new requirements take effect on July 1, 2013. (Notably, compliance with the requirements with respect to the independence of compensation committee members is not necessary until the earlier of a listed company's first annual meeting of shareholders occurring after January 15, 2014 or October 31, 2014—although, as discussed below, companies should begin preparing to comply with these requirements now.)

Of course, the requirement to consider compensation consultant conflicts of interest has already taken effect. It was applicable to any proxy or information statement for an annual meeting of shareholders (or a special meeting in lieu of the annual meeting) at which directors will be elected occurring on or after January 1, 2013.

This issue discusses what companies should be doing now in advance of the July 1st deadline.

Ensuring the Independence of Your Compensation Committee Members

Exchange Act Rule 10C-1(b)(1) requires the national securities exchanges to revise their list-

ing standards to require that each member of the board compensation committee of a listed company be a member of the company's board of directors and otherwise "independent." For purposes of developing rules to implement this latter requirement, the national securities exchanges were required to consider relevant factors, including, but not limited to:

- The source of compensation of a member of the board of directors, including any consulting, advisory, or other compensatory fee paid by the listed company to such individual (the "Compensation Factor"); and
- Whether a member of the board of directors is affiliated with the listed company, a subsidiary of the listed company, or an affiliate of a subsidiary of the listed company (the "Affiliation Factor").

NYSE-Listed Companies. In the case of an exchange-listed company, the NYSE is requiring the board of directors to determine the independence of any director who will serve on the board compensation committee. Specifically, the board of directors is to affirmatively consider all factors relevant to determining whether the director has a relationship with the company that is material to his or her ability to be independent from management when serving on the committee, including, but not limited to, the Compensation Factor and the Affiliation Factor (see NYSE Listed Company Manual Section 303A.05(b)(iii) and (c)).

For this purpose, when evaluating the sources of directors' compensation, the board of directors should consider whether they receive compensation from any persons or entities that would impair their ability to make independent judgments about the company's executive compensation. Similarly, when evaluating any affiliate relationships directors have with the company (or a subsidiary), in determining their independence, the board of directors should consider whether the affiliate relationship places the directors under the direct or indirect control of the company or its senior management, or creates a direct relationship between directors and members of senior management, in each case of a nature that would impair their ability to make independent judgments about the company's executive compensation (see the NYSE Listed Company Manual Commentary to Section 303A.02(a)).

Nasdaq-Listed Companies. In the case of an exchange-listed company, the Nasdaq Stock Market is requiring the board of directors to constitute

a formal compensation committee with at least two members (to the extent that the company does not already have such a committee), each of whom is an independent director as defined under the Nasdaq rules, and who is not receiving, either directly or indirectly, any consulting, advisory or other compensatory fee from the company (or any subsidiary) (see Nasdaq Stock Market Listing Standards Rule 5605(d)(2)). In addition, the board of directors must also consider the Affiliation Factor to determine whether any affiliation would impair the director's judgment as a member of the compensation committee.

For this purpose, the term "compensatory fee" does not include (i) fees received as a member of the compensation committee, the board of directors or any other board committee or (ii) the receipt of fixed amounts of compensation under a retirement plan (including deferred compensation) for prior service with the company (provided that such compensation is not contingent in any way on continued service) (see Nasdaq Stock Market Listing Standards Rule 5605(d)(2)).

What You Should be Doing. Although most companies have more than a year to comply with the board compensation committee independence requirement, given the amount of time necessary to reconstitute the committee (which potentially may involve identifying, recruiting, and appointing one or more new directors), companies should begin to evaluate the qualifications of their compensation committee members now.

In addition, companies should consider whether any revisions to their current director and officer ("D&O") questionnaire are necessary to be able to identify any change in circumstances that may necessitate a closer examination of the current committee members. For many companies, the existing questions directed towards determining whether compensation committee members qualify as "outside" directors (for purposes of the "performance-based compensation" exception to Section 162(m) of the Internal Revenue Code) and "non-employee" directors (for purposes of Exchange Act Rule 16b-3) may be sufficient to address this matter. As a practical matter, it's unlikely that a director who fails to qualify as an "outside" or "non-employee" director is going to be independent for purposes of the applicable listing standards.

Companies should also consider asking compensation committee members to identify any

relationship that they have with the company, a subsidiary or any affiliated entity. Neither the SEC rules nor the listing standards of the national securities exchanges provide a specific definition of the term "affiliate" for this purpose. Accordingly, we expect that companies will use the body of law that has developed under the federal securities law when evaluating this factor.

While companies with calendar-year fiscal year-ends have some time to update their D&O questionnaire, companies with other fiscal year-ends should begin this process shortly. This will be particularly true for Nasdaq-listed companies, where the receipt of any consulting, advisory, or other compensatory payment from the company acts as an absolute prohibition on committee membership.

It is worth noting that the D&O questionnaire may serve a secondary purpose related to the required assessment of the independence of compensation committee advisers. While not required, a company should consider inquiring as to whether their executive officers and compensation committees have any contacts with the individuals employed by the committee's compensation consultant and legal adviser that may rise to the level of a personal or business relationship. While such an inquiry is, in and of itself, insufficient to satisfy the compensation committee's duty to assess the independence of its advisers, it does offer a potentially useful way to spot relationships that may require further analysis.

In addition, a Nasdaq-listed company must certify in writing to the Nasdaq, within 30 days after the final applicable implementation date, that it has complied with the independence provisions of Rule 5605(d) and agree that the committee will review and reassess the adequacy of this written charter on an annual basis (see Nasdaq Stock Market Listing Standards Rule 5605(d)(1)).

Assessing the Independence of Compensation Committee Advisers

Exchange Act Rule 10C-1(b)(4) requires the national securities exchanges to revise their listing standards to specify that the compensation committee of a listed company may select a compensation consultant, legal counsel or other adviser only after taking into consideration the following factors, as well as any other factors identified by the relevant national securities exchange in its listing standards (collectively, the "Independence Factors"):

- 4** – The provision of other services to the company by the person that employs the adviser;
- The amount of fees received from the company by the person that employs the adviser, as a percentage of the total revenue of the person that employs the adviser;
 - The policies and procedures of the person that employs the adviser that are designed to prevent conflicts of interest;
 - Any business or personal relationship of the adviser with a member of the compensation committee;
 - Any stock of the company owned by the adviser; and
 - Any business or personal relationship of the adviser or the person employing the adviser with an executive officer of the company.

In addition, the provision states that the board compensation committee is required to conduct this independence assessment with respect to any compensation consultant, legal counsel or other adviser that provides advice to the compensation committee, other than in-house legal counsel.

NYSE-Listed Companies. In the case of an exchange-listed company, the NYSE is prohibiting the board compensation committee from selecting a compensation consultant, legal counsel or other adviser unless it first takes into consideration all factors relevant to that person's independence from management, including the Independence Factors (see above). The NYSE did not identify any additional factors to be considered in making this independence assessment.

Significantly, the NYSE does not require that the compensation consultant, legal counsel or other adviser ultimately selected by the board compensation committee be independent. A board compensation committee may select, or receive advice from, any compensation adviser it prefers, including ones that are not independent, as long as it has first considered the Independence Factors.

Nasdaq-Listed Companies. In the case of an exchange-listed company, the Nasdaq Stock Market is prohibiting the board compensation committee from selecting a compensation consultant, legal counsel or other adviser unless it first takes into consideration all factors relevant to that person's independence from management, including the Independence Factors (see Nasdaq Stock Market Listing Standards Rule 5605(d)(3)(D)). Like the NYSE, the Nasdaq Stock Market did not identify

any additional factors to be considered in making this independence assessment.

Further, the Nasdaq Stock Market does not require that the compensation consultant, legal counsel or other adviser selected by the board compensation committee be independent, only that the committee consider the Independence Factors before selecting, or receiving advice from, an adviser. Like NYSE-listed companies, board compensation committees may select, or receive advice from, any compensation adviser it prefers, including ones that are not independent, after considering the Independence Factors.

Situations When Independence Assessment Not Required. Both the NYSE and the Nasdaq Stock Market have carved out exceptions to the independence assessment requirement. These exceptions apply to any adviser that (i) acts in a capacity limited to consulting on any broad-based plan that does not discriminate in scope, terms, or operation, in favor of executive officers or directors, and that is available generally to all salaried employees; and/or (ii) provides information that either is not customized for a particular company or that is customized based on parameters that are not developed by the adviser, and about which the adviser does not provide advice.

What You Should Be Doing. Companies have until July 1, 2013 to ensure that their board compensation committees assess the independence of their advisers. While the rules contemplate that this assessment will be conducted before a potential adviser is selected, the initial assessments will involve the compensation committee's current advisers. In most instances, this will involve assessing the independence of their compensation consultants and, as discussed below, any legal counsel from whom they have received advice.

Compensation Consultants. In the case of compensation consultants that have been engaged by the board compensation committee, it's possible that this independence assessment has already been conducted in connection with the company's determination of whether the consultant's work has raised a conflict of interest for disclosure purposes. If not, however, the compensation committees should take action to complete this evaluation prior to July 1st.

Many compensation committees, either directly or through the company's legal counsel, have reached out to their compensation consultant, typically using a written set of questions which

conform to the Independence Factors, to elicit the information needed to make the independence determination. At the same time, the committee has worked with the company (principally through the company's dissemination and collection of the D&O questionnaire) to obtain any information about potential personal and business relationships that may exist between the individual consultants who work with the committee and the committee members and the company's executive officers.

As a practical matter, since much of the information underlying the Independence Factors is in the possession of the compensation consultants themselves, several consultants have affirmatively sent letters or memoranda to their board compensation committee clients summarizing their responses to each relevant factor. We expect that this practice will continue as an ongoing aspect of their engagement.

As the SEC has noted, on an ongoing basis, this assessment should be conducted annually. Given the related conflicts of interest disclosure requirement, we expect that most companies will coordinate this assessment with this disclosure inquiry to take place at or near the end of the fiscal year. In fact, this assessment may involve an affirmative presentation to the board compensation committee by the compensation consultant summarizing their responses to the relevant Independence Factors, with an opportunity for committee members to engage in a discussion with the consultant about his or her independence and that of his or her team and/or firm.

Legal Counsel. To date, few board compensation committees have engaged separate legal counsel to support the committee's work. Consequently, most companies will face the question of whether their board compensation committees need to conduct an independence assessment of the company's outside legal counsel. (The SEC rules make clear that no assessment is required with respect to in-house legal counsel.) The NYSE listing standards and Nasdaq rules make it clear that the independence assessment requirement applies to the receipt of advice from outside legal counsel, whether or not that advice pertains to executive compensation matters.

Where the board compensation committee affirmatively seeks input from the company's outside legal counsel in connection with a specific issue, whether related to a corporate governance, compensation, or other matter, the answer should be

straightforward. However, where the provision of advice is indirect (such as where the committee seeks advice from the company's in-house legal counsel who, in turn, consults the company's outside legal counsel) or where the compensation committee is unaware that the advice it is receiving from in-house legal counsel has been previously vetted by outside legal counsel, a more difficult question is presented.

For purposes of these initial assessments, it will be necessary for the board compensation committee, in consultation with the company (through in-house legal counsel or the corporate secretary) to review each of the principal activities on its annual calendar, identify the role (if any) of the company's outside legal counsel in the activity, and determine whether the counsel's role involves providing advice to the committee. Ultimately, these determinations depend on the facts and circumstances of each situation. Thereafter, the board compensation committee will need to be sensitive to the potential role of outside legal counsel as it carries out its responsibilities throughout the year so as to identify whether such counsel will need to be a subject of its annual independence review.

Documentation of Assessment. Interestingly, while the board compensation committee must conduct an independence assessment, there is no requirement that the assessment be documented, or that the committee reach an affirmative conclusion about the outcome of the assessment. Nonetheless, we expect that most board compensation committees will memorialize their actions in the minutes of committee meetings, attaching any associated documentation (typically, the facts gathered with respect to the Independence Factors and any related analysis) to the minutes.

Further, as seen in numerous proxy statement disclosures this year, companies have also been making an affirmative statement of the results of their independence assessment (that is, that the board compensation committee has determined that its compensation consultant is independent) as part of their voluntary disclosure about any consultant conflicts of interest (see below).

Updating Your Compensation Committee Charter

Exchange Act Rule 10C-1(b)(2) and (3) direct the national securities exchanges to require listed companies to:

6 • Ensure that the board compensation committee, in its sole discretion, has the authority to retain or obtain the advice of a compensation consultant, independent legal counsel or other adviser;

• Ensure that the board compensation committee is directly responsible for the appointment, compensation and oversight of the work of any compensation consultant, independent legal counsel and other adviser retained by the compensation committee; and

• 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 to a compensation consultant, independent legal counsel or any other adviser retained by the compensation committee.

As implemented by the listing standards of the national securities exchanges, these responsibilities and authority must be included in the board compensation committee's charter (see NYSE Listed Company Manual Section 303A.05(b)(iii) and (c) and Nasdaq Stock Market Listing Standards Rule 5605(d)(1)(D) and (3)), along with the following additional responsibility:

• Confirm that the board compensation committee may select a compensation consultant, legal counsel or other adviser only after having taken into consideration all factors relevant to that person's independence from management, including the six independence factors set forth in Exchange Act Rule 10C-1(b)(4).

What You Should Be Doing. At the majority of NYSE-listed companies, these responsibilities and authority are already likely to be included in the board compensation committee's charter (with the exception of independence assessment requirement). Thus, at a minimum, prior to July 1, 2013, each NYSE-listed company should review its existing charter to ensure that it adequately addresses each of these items.

In the case of a Nasdaq-listed company, where charters (and, for that matter, compensation committees) were not previously required, these responsibilities and authority must be reflected in the board compensation committee's charter by the earlier of a listed company's first annual meeting of shareholders occurring after January 15, 2014 or October 31, 2014. As a practical matter, we expect that most Nasdaq-listed com-

panies are likely to either draft an appropriate new charter (if they don't have one) or update their existing charter by July 1, 2013. Failing that, they will need to take some formal action to document that these responsibilities and authority have been appropriately delegated to the board compensation committee.

In addition, a Nasdaq-listed company must certify in writing to the Nasdaq, within 30 days after the final applicable implementation date, that it has complied with the compensation committee charter requirement of Rule 5605(d) and agree that the committee will review and reassess the adequacy of this written charter on an annual basis (see Nasdaq Stock Market Listing Standards Rule 5605(d)(1)).

Disclosing Compensation Consultant Conflicts of Interest

In addition to its primary objectives, Section 10C(c)(2) of the Exchange Act also requires companies to disclose in their proxy or consent solicitation materials for an annual meeting of shareholders (or a special meeting in lieu of the annual meeting) specific information about any compensation consultant that was retained by the board compensation committee or from which it obtained advice. In June 2012, the SEC added new Item 407(e)(3)(iv) to Regulation S-K to implement this requirement in connection with annual meetings of shareholders at which directors are to be elected taking place on or after January 1, 2013 (see Securities Act Release 9330 (Jun. 20, 2012)). Specifically, Item 407(e)(3)(iv) provides that:

With regard to any compensation consultant identified in response to Item 407(e)(3)(iii) whose work has raised any conflict of interest, disclose the nature of the conflict and how the conflict is being addressed.

After initially proposing to integrate the requirements of Section 10C(c)(2) into its existing disclosure framework for disclosure of the role of any party that is involved in determining or recommending the amount or form of executive or director compensation, the SEC opted to retain the existing framework and simply add a new paragraph to require the disclosures mandated by Section 10C(c)(2).

Notably, this decision has resulted in a slightly broader group of relationships being potentially subject to disclosure. Item 407(e)(3)(iv) expressly

applies its disclosure requirement to “any compensation consultant identified in response to Item 407(e)(3)(iii).” The compensation consultants described in Item 407(e)(3)(iii) include any consultant with any role “in determining or recommending the amount or form of executive and director compensation.” (Specifically, the SEC indicated that it believed that this standard satisfied the “retained or obtained the advice” disclosure trigger contemplated by Section 10C(c)(2).) The practical import of this decision means that the new conflict of interest disclosure requirement applies to compensation consultants retained by management or any other board committee, as well as compensation consultants retained by the compensation committee.

Thus, under Item 407(e)(3), in providing a narrative description of a company’s processes and procedures for the consideration and determination of executive and director compensation, a company continues to be required to disclose information about any role of compensation consultants in determining or recommending the amount or form of executive and director compensation. Specifically, this involves providing the following information:

- Identity of the consultant or consultants;
- Statement as to whether the consultant (or consultants) were engaged directly by the compensation committee or any other person;
- Description of the nature and scope of the consultant’s assignment and the material elements of any instructions given to the consultant under the engagement; and
- Aggregate fees paid to the consultant for advice or recommendations on the amount or form of executive and director compensation and the aggregate fees for additional services if the consultant provided both and the fees for the additional services exceeded \$120,000 during the fiscal year.

And, in the event that the consultant’s work raised a conflict of interest, the company must now also provide a description of the nature of the conflict and how it is being addressed.

The Consequences of the New Disclosure. This new compensation consultant conflict of interest disclosure requirement will have three immediate consequences.

The first involves the determination as to whether disclosure is required. While there are no

specific standards for making this determination, the Instruction to Item 407(e)(3)(iv) provides that the six independence factors listed in Exchange Act Rule 10C-1(b)(4)(i) through (vi) (as set forth above) are among the factors that should be considered in determining whether a conflict of interest exists. As a practical matter, companies are likely to rely heavily on these six factors, as well as any specific facts and circumstances to their unique situation, as the basis for identifying any potential or actual conflicts of interest.

Second, even though this disclosure requirement is imposed on the company, since the six independence factors are the same factors that must be considered by the board compensation committee when assessing the independence of its advisors, it is expected that companies will coordinate its disclosure determination with the committee’s independence assessment and, in some instances, may largely cede this responsibility to the compensation committee. As a result of this congruity, as well as the need to make the disclosure determination in connection with the preparation of the proxy materials for the company’s annual meeting of shareholders, it is further expected that most board compensation committee’s will schedule their independence assessment of existing advisers for the end of the fiscal year so as to coincide with the disclosure determination.

Finally, similar to the approach taken for purposes of the compensation-related risk disclosure requirement in Item 402(s) of Regulation S-K, disclosure is required pursuant to Item 407(e)(3)(iv) only to the extent that a conflict of interest is identified. To date, we have not yet encountered a company that has identified and disclosed a potential or actual conflict of interest. Accordingly, most (if not all) companies are expected to determine that no disclosure is required. Nonetheless, at least during the 2013 proxy season, many companies are providing so-called “negative disclosure” (that is, disclosure that affirmatively states that no conflict of interest exists) in their proxy statement to reassure the SEC Staff—and their shareholders—that they are aware of and have considered the new disclosure requirement.

The Initial Disclosures. Most companies have expressly addressed the new disclosure requirement—in the form of a negative disclosure statement—in their proxy materials (see the examples beginning on pg 8).

The Initial Disclosures—Examples

In virtually every instance, the disclosure has been located either in the Corporate Governance section of the proxy statement (typically, in the section addressing the role and responsibilities of the board compensation committee) or in the Compensation Discussion and Analysis (typically, in the section addressing the company's executive compensation-setting process).

While these disclosures vary in scope and content among companies, so far they have fallen into one of three broad categories.

General Statement of Conflict of Interest Conclusion. Most companies have simply added an additional statement to the general description of the role and responsibilities of the compensation consultant to their board compensation committee. For example, Littelfuse included the following paragraph in the Corporate Governance section of its proxy statement:

The Compensation Committee continued to engage Compensation Strategies, Inc. during the 2012 fiscal year to assist it with compiling a comprehensive analysis of market data and analyzing its implications for executive compensation at the Company, as well as various other executive compensation issues. Compensation Strategies, Inc., which was first engaged by the Compensation Committee in August 2007, provided the following services in 2012: (1) reviewed our annual bonus and long-term incentive programs; (2) reviewed the executive compensation philosophy; and (3) provided an update on executive compensation trends and pending and enacted legislation relevant to the compensation of our executive officers. Compensation Strategies continued to work with the Compensation Committee throughout the year with respect to these issues and as requested by the Compensation Committee. The Compensation Committee determined that Compensation Strategies, Inc. did not have any economic interests or other relationships that would conflict with their obligation to provide impartial and objective advice

Other companies took a more indirect approach, but essentially made the same statement. For example, Agilent Technologies included the following paragraph in the Executive Summary to its Compensation Discussion and Analysis:

An independent Compensation Committee compensation consultant, F.W. Cook, retained directly by the Compensation Committee and who performs no other work for Agilent; does not trade Agilent stock; has an Independence Policy that is reviewed annually by F.W. Cook's Board of Directors; and proactively notifies the Compensation Committee chair of any potential or perceived conflicts of interest.

Detailed Discussion of Conflict of Interest Conclusion. Several companies, particularly larger companies, have elaborated on how they have arrived at their conclusion that no conflict of interest exists, typically citing the six independence factors as the basis for the conclusion. For example, GTx included the following paragraph in its Compensation Discussion and Analysis:

In February 2013, the Compensation Committee analyzed whether the work of Radford as a compensation consultant has raised any conflict of interest, taking into consideration the following factors: (i) the provision of other services to our company by Radford; (ii) the amount of fees from our company paid to Radford as a percentage of the firm's total revenue; (iii) Radford's policies and procedures that are designed to prevent conflicts of interest; (iv) any business or personal relationship of Radford or the individual compensation advisors employed by the firm with an executive officer of our company; (v) any business or personal relationship of the individual compensation advisors with any member of the Compensation Committee; and (vi) any stock of our company owned by the individual compensation advisors employed by the firm. The Compensation Committee determined, based on its analysis of the above factors, that the work of Radford and the individual compensation advisors employed by Radford as compensation consultants to our company has not created any conflict of interest. Going forward, the Compensation

Committee intends to assess the independence of any of our compensation advisers by reference to the foregoing factors, consistent with applicable Nasdaq listing standards.

Other companies expanded on this approach by providing the outcome of their consideration of each of the six independence factors. For example, Sanmina included the following description in its Compensation Discussion and Analysis:

The Committee retained Compensia, Inc., an executive compensation consulting firm, to provide advice on executive pay issues. During fiscal 2012, the Committee directed Compensia to review for accuracy and completeness the analysis of peer company compensation data and materials provided by management to the Committee, to provide the Committee with information regarding compensation trends generally, as well as industry specific compensation trends and to answer questions the Committee posed regarding compensation issues. The Committee has engaged Compensia to conduct a similar review of Sanmina's executive compensation program for fiscal 2013.

As a result of new SEC rules, Sanmina is required to disclose whether the work of its compensation consultant raises any conflict of interest issues and, if so, the nature of the conflict and how the conflict was addressed. The Committee does not believe that the retention of Compensia to advise it concerning executive compensation matters creates a conflict of interest. The Committee's belief in this regard is informed by the following:

- According to Compensia, revenue from Sanmina represented less than 1% of Compensia's total revenue for fiscal 2012;
- Compensia has adopted and disclosed to the Committee its conflicts of interest policy concerning client engagements and the Committee believes such policy provides reasonable assurance that conflicts of interest with Compensia will not arise;
- There are no business or personal relationships between Compensia and any member of the Committee; and
- Compensia has represented to the Committee that, per its conflicts of interest policy, no Compensia employee is a stockholder of Sanmina.

In addition, Compensia reported solely to the Committee, Sanmina's management was not involved in the negotiation of fees charged by Compensia or in the determination of the scope of work performed by Compensia and the Committee has the sole authority to hire and terminate compensation consultants. As a result of the foregoing, the Committee believes that Compensia is independent of Sanmina.

Statement on Compensation Consultant Independence and Conflict of Interest Conclusion. In view of the overlap between the conflicts of interest disclosure requirement and the compensation committee adviser independence assessment—as well as the looming effective date for conducting the adviser independence assessment, it's no surprise that a number of companies opted to address both of these items in their voluntary disclosure. For example, AmerisourceBergen included the follow discussion of its board compensation committee use of an external compensation consultant in the Corporate Governance section of its proxy statement:

The Committee has sole authority to engage an executive compensation consultant and to terminate the engagement of any such consultant. The Committee's consultant must be independent and objective. No firm will be disqualified solely on the basis of fees, provided it has not received more than \$120,000 in the aggregate for the performance of any other services for AmerisourceBergen during the fiscal year. Pay Governance LLC served as the Committee's executive compensation consultant in 2012 pursuant to a written consulting agreement, subject to annual review. Following a review of Pay Governance in accordance with SEC and proposed NYSE rules regarding compensation consultants, the Committee determined that Pay Governance was independent and did not have any economic interests or other relationships that would conflict with Pay Governance's

obligation to provide the Board with impartial and objective advice on compensation trends and practices.

Other companies have foregone the subject of conflicts of interest entirely and simply addressed the results of the board compensation committee's adviser independence assessment (perhaps on the basis that the presence or absence of a conflict of interest is simply one aspect of determining an adviser's independence). For example, Gencorp included the following discussion in its Compensation Discussion and Analysis:

The Organization & Compensation Committee retains Hay Group to provide objective analysis, advice and information to the Organization & Compensation Committee, including competitive market data and compensation recommendations related to the President and CEO and other senior executives. Hay Group served as the independent executive compensation consultant to the Organization & Compensation Committee during fiscal year 2012. The executive compensation consultant reports to the Chairman of the Organization & Compensation Committee and has direct access to the other members of the Organization & Compensation Committee as well as senior management. The total fees for the services provided by the Hay Group to the Company and paid in fiscal year 2012 were \$154,591.

In addition to the compensation services provided by Hay Group to the Organization & Compensation Committee, Hay Group provided certain services to the Company at the request of management consisting of advice relating to the design of the Company's broad-based employee annual incentive plans. The Company paid \$24,194 to Hay Group in fiscal year 2012 for such services which is included in the \$154,591 total disclosed in the previous paragraph. The Organization & Compensation Committee believes that, given the nature and scope of these additional services, these additional services did not raise a conflict of interest and did not impair Hay Group's ability to provide independent advice to the Organization & Compensation Committee concerning executive compensation matters.

In making the overall determination of Hay Group and Hay Group's lead advisor to the Organization & Compensation Committee independence, the Organization & Compensation Committee considered, among other things, the following factors: (i) the types of non-executive compensation consulting services provided by Hay Group to the Company, (ii) the amount of fees for executive and non-executive compensation consulting services, noting in particular that such fees are negligible when considered in the context of Hay Group's total revenues for the period, (iii) Hay Group's policies and procedures concerning conflicts of interest, (iv) there are no other business or personal relationships between members of the Organization & Compensation Committee and Hay Group's lead advisor to the Company, (v) the lead Hay Group advisor who provides executive and non-executive compensation consulting services to the Company does not own any GenCorp common stock, and has agreed not to purchase any such stock so long as Hay Group and the lead advisor is engaged to provide executive compensation advisory services to the Organization & Compensation Committee (any Company stock held or managed through a third party (e.g., qualified retirement benefit plan and mutual fund) in which the lead advisor has an interest is not considered stock owned by the adviser for purposes of this sentence), (vi) there are no other business or personal relationships between the Company's executives and the lead Hay Group advisor, and (vii) any other factors relevant to the independence of the executive compensation consultant.

The decisions made by the Organization & Compensation Committee are the responsibility of the Organization & Compensation Committee and may reflect factors and considerations other than the information and recommendations provided by Hay Group.

In fiscal 2011, the Company retained Hay Group to provide ad hoc consulting related to executive compensation. The total fees for the services provided by Hay Group to the Company in fiscal year 2011 were \$26,846.

Future Disclosures. No doubt, after July 1, we expect that we will see most companies providing “negative” disclosure about the absence of conflicts of interest arising from their compensation consultant relationships also include a statement indicating that the board compensation committee has determined that its compensation consultant is independent.

It is less clear whether this disclosure will extend to other advisers to the board compensation committee. Part of this is based on the limited number of compensation committees that, to date, have engaged separate legal counsel or other advisers. In addition, at this time it is problematic as to how the board compensation committee and the company’s outside legal counsel will answer the question of whether the counsel has provided advice to the committee.

More to Come?

In view of the leadership transition underway at the SEC, it’s possible that Section 952 of Dodd-Frank will be the only new corporate governance or executive compensation-related provision to become effective this year. That still leaves at least four major provisions to be implemented. We expect that the SEC won’t take 18 months (the time span between the effective dates of Sections 951 and 952) to let us know what’s next.

We thank Mark Borges of Compensia for contributing this article.

Final Cost-Basis Reporting Regs— Bad News for Stock Compensation

It’s been a long road that started with the Economic Stabilization Act of 2008, but in late April, the IRS finalized the last phase of regulations necessary to fully implement cost-basis reporting. This phase primarily addresses basis reporting for debt instruments and tradable options but it includes a provision relating to stock compensation.

Since 2011, brokers have been required to include cost basis for sales of stock reported on Form 1099-B. As we noted in our September-October 2011 issue at pg 7, the basis reported for sales of stock acquired under employee stock options and ESPPs (full value awards are not subject to this reporting) does not have to include compensation income recognized in connection with the arrangement even though this income is

part of the basis. Originally, this exclusion was only available until 2013, then in late 2011, the IRS issued proposed regs that extended the exclusion indefinitely. Despite the availability of this exclusion, many brokers voluntarily report the full basis on Forms 1099-B for sales of shares acquired under NQSOs and shares acquired under ISOs that are sold in a broker-assisted cashless transaction (for ESPPs, brokers often do not have sufficient information to report the correct basis and, consequently, end up reporting only the purchase price as the basis).

We were disheartened in 2011 when the IRS extended the ability to exclude compensation income from the basis indefinitely. Now we are more disheartened to learn that the final regs not only retain this indefinite exclusion, but go one step further to prohibit brokers from voluntarily including compensation income in the basis. Beginning with transactions in 2014, the cost basis reported on Form 1099-B for shares acquired under employee stock options must be limited to the amount paid for the stock. Moreover, there will not be any indicator on the form to alert executives to the fact that the basis may not be correct or even that the shares were acquired under a stock option or ESPP.

We understand that the IRS included this prohibition to ensure consistency in how sales of stock will be reported. We agree that consistency is an admirable goal, but we would have preferred consistency in the other direction—*i.e.*, requiring brokers to accurately report the correct basis whenever possible. In today’s information age, it certainly seems like this should be possible for many sales of shares acquired under stock plans (the fact that brokers have been voluntarily reporting the correct basis proves this point). And, in any event, because the final regulations only apply to stock acquired after January 1, 2014, we’re not sure consistency has been achieved. Depending on when the shares were acquired, Forms 1099-B for sales of share acquired under stock plans may not indicate any basis (shares acquired before January 1, 2011), may indicate the correct basis (shares acquired from January 1, 2011 to December 31, 2013), or may indicate only the amount paid as the basis (shares acquired after January 1, 2014).

Limiting the basis to the amount paid for the stock underreports the basis in almost all cases. The only sales for which the amount paid is the correct basis are qualifying dispositions of ESPP

shares where the stock is sold at an economic loss (not just a tax loss) and qualifying dispositions of ISO shares (regardless of whether the stock is sold at a gain or loss). To avoid double-taxation where the basis is underreported, executives will have to report an adjustment to their capital gain/loss on Form 8949 when they file their tax return.

A Silver Lining: Proceeds Net of Fees

A bit of good news, however, is that beginning in 2014, brokers will be required to report all proceeds on Form 1099-B net of transaction fees (currently brokers can choose to report either net or gross proceeds). This small change will make it significantly easier to explain to executives how to report stock plan transactions on their tax return.

We thank Andrew Schwartz of Computershare for bringing this development to our attention.

Our Pair of Popular Executive Pay Conferences: 15% Early Bird Discount

Act now to join 2000 of your colleagues at our popular pair of conferences—"Tackling Your 2014 Compensation Disclosures: The Proxy Disclosure Conference" & "Say-on-Pay Workshop: 10th Annual Executive Compensation Conference"—to be held September 23-24th in Washington DC and via Live Nationwide Video Webcast. The full agendas for the Conferences are posted on TheCorporateCounsel.net—but the panels include:

- Q&A with ISS
- Q&A with Glass Lewis
- Say-on-Pay Shareholder Engagement: The Investors Speak
- Compensation Committees & Advisors: The NYSE & Nasdaq Speak
- Realizable Pay Disclosure: How to Do It
- How to Improve Pay-for-Performance Disclosure
- We Don't Have a Good Pay Story: What Do We Disclose?

- How to Avoid Executive Pay Disclosure Litigation
- Peer Group Disclosures: What to Do Now
- In-House Perspective: Strategies for Effective Solicitations
- The SEC Staff Review Process
- Creating Effective Clawbacks (and Disclosures)
- Pledging & Hedging Disclosures
- The Executive Summary
- The Art of Supplemental Materials
- Dealing with the Complexities of Perks
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- Shareholder Proposals & Executive Pay
- The Rise of Political Contribution Disclosures

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Here are critical webcasts coming up soon:

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- TheCorporateCounsel.net's webcast—"Social Media: Parsing the Hypos" (5/8)
- DealLawyers.com's webcast—"Conflicts of Interest: How to Handle in Deals" (6/6)
- TheCorporateCounsel.net's webcast—"A Proxy Season Post-Mortem: Lessons Learned" (6/11)
- CompensationStandards.com's webcast—"Proxy Season Post-Mortem: The Latest Compensation Disclosures" (6/12)
- TheCorporateCounsel.net's webcast—"Dealing with the Board: Presentations, Etiquette & More" (10/9)

—BB

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