Complying with New Compensation Committee and Compensation Adviser Independence Standards

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The national securities exchanges, as required by the Dodd-Frank Act, have proposed amendments to their listing requirements relating to compensation committees. These amendments require that:

- Each member of the compensation committee be "independent";
- Compensation committee charters specify the compensation committee's authority to engage compensation consultants, legal counsel and other advisers (collectively, "compensation advisers"); and
- The compensation committee consider the "independence" of any compensation adviser (other than in-house legal counsel) before engaging the compensation adviser.

Complying with these proposed amendments will require that financial institution holding companies amend the (or, in some cases, adopt a) compensation committee charter and take certain other actions, as described below, beginning in mid-2013.

These compensation committee requirements apply only to financial institution holding companies whose securities are traded on the national securities exchanges (i.e., NYSE, NYSE MKT, NASDAQ, etc.). Other financial institution holding companies and financial institutions should keep these standards in mind as "best practices" and be prepared for the possibility that similar requirements may be imposed through the bank regulatory process.

Compensation Committee Independence

The Dodd-Frank Act and new Rule 10C-1 under the Securities Exchange Act of 1934 require that the members of the compensation committee be "independent" under rules proposed by the national securities exchanges. NYSE and NYSE MKT have taken a substantially different approach from that of NASDAQ to ensure that listed financial institution holding companies satisfy this standard.

NYSE; NYSE MKT

Under current NYSE rules, all directors are required to satisfy a two-part independence test. First, the director cannot violate one of five "bright-line" tests. Second, the full board of directors must affirmatively determine that the director does not have any material relationship with the holding company.

Under NYSE MKT rules, all directors are required to also satisfy a two-part independence test. First, the director cannot violate one of six "bright-line" tests. Second, the full board of directors must affirmatively determine that the director does not have any relationship that would interfere with the exercise of independent judgment in carrying out the responsibilities of a director.

Each of NYSE and NYSE MKT is proposing to amend its standards to require that, with respect to compensation committee members, the full board of directors also affirmatively determine the independence of any member of the compensation committee by considering "all factors specifically relevant to determining whether a director has a relationship with the listed company [and its subsidiaries] which is material to that director's ability to be independent from management in connection with the duties of a compensation committee member". These factors include:

- The director's sources of compensation, including any consulting, advisory or other compensatory fee paid by the listed company or any of its subsidiaries; and
- Whether the director is affiliated with the listed company, a subsidiary of the listed company, or any affiliate of a subsidiary of the listed company.

Financial institution holding companies would be required to comply with these new independence requirements for compensation committee members by the earlier of the first annual meeting after January 15, 2014, or October 31, 2014.

NASDAQ

Unlike the proposals of NYSE and NYSE MKT, the amendments proposed by NASDAQ to its listing standards contemplate more significant changes.

Under current NASDAQ rules, all directors are required to satisfy a two-part independence test. First, the director cannot violate one of six "bright-line" tests. Second, the full board of directors must make an affirmative determination that the director does not have a relationship that would interfere with the exercise of his or her independent judgment in carrying out the responsibilities of a director.

NASDAQ is proposing three significant changes to these rules as they relate to compensation committee members (or, in the absence of a compensation committee, those directors who are responsible for compensation of executive officers):

- First, all financial institution holding companies will be required to maintain a separate compensation committee that has a written charter. As a result, the prior exception under which compensation decisions involving executive officers could be approved by a vote of all independent directors will no longer be available.
- Second, no compensation committee member may accept, directly or indirectly, any consulting, advisory or other compensatory fee from the listed company or any subsidiary, other than fees received as a member of the board of directors or a board committee, or fixed amounts under a retirement plan including deferred compensation for prior service with the listed company and its subsidiaries (provided that the compensation is not contingent in any way on continued service).
- Third, when determining whether a director is eligible to serve on the compensation committee, financial institutions must also consider whether the director is affiliated with the listed company, a subsidiary of the listed company, or an affiliate of a subsidiary of the listed company to determine whether such affiliation would impair the director's judgment as a member of the compensation committee.

Financial institution holding companies would have until the earlier of the first annual meeting held after January 15, 2014, or October 31, 2014, to comply with the provisions relating to compensation committee independence and adopt a formal written compensation committee charter.

Compensation Adviser Access

The Dodd-Frank Act and new Rule 10C-1 under the Securities Exchange Act of 1934 require that the compensation committee have access to compensation advisers who are independent. For this purpose, the compensation committee must: (i) in its sole discretion, have the ability to retain or obtain the advice of a compensation adviser; (ii) be directly responsible for the appointment, compensation and oversight of the work of any compensation adviser retained by the compensation committee; and (iii) be provided with appropriate funding by the listed company for payment of reasonable compensation to such compensation adviser.

Each of NYSE, NYSE MKT and NASDAQ is requiring that this authority be expressly included in the compensation committee charter.

For NYSE and NYSE MKT listed companies, these obligations would become effective on July 1, 2013.

For NASDAQ listed companies, these obligations would become effective on July 1, 2013, but amendments to the compensation committee charter would not be required until the earlier of the first annual meeting held after January 15, 2014, or October 31, 2014.

Compensation Adviser Independence

The Dodd-Frank Act and new Rule 10C-1 under the Securities Exchange Act of 1934 require that, before engaging an individual compensation adviser (other than in-house legal counsel), the compensation committee consider all factors relevant to that person's independence from management, including the following:

- Any other services provided to the listed company and its subsidiaries by the person who employs the individual compensation adviser;
- The amount of fees received from the listed company and its subsidiaries by the person who employs the individual compensation adviser as a percentage of the employer's total revenue;
- The policies and procedures of the person who employs the individual compensation adviser that are designed to prevent conflicts of interest;
- Any business or personal relationship of the individual compensation adviser with a member of the compensation committee;
- Any stock of the listed company owned by the individual compensation adviser; and
- Any business or personal relationship between the listed company's executive officers and the individual compensation adviser or the person employing such individual.

Each of NYSE, NYSE MKT and NASDAQ makes clear that the compensation committee is not required to select a compensation adviser that is independent, but must conduct the independence assessment before engaging any such compensation adviser.

NYSE and NYSE MKT have proposed adopting this six-factor test essentially verbatim and requiring that the compensation committee charter expressly address the obligation to conduct this independence assessment. For NYSE and NYSE MKT listed companies, these obligations would become effective on July 1, 2013.

NASDAQ also has proposed adopting this six-factor test, but, unlike NYSE and NYSE MKT, does not require that financial institution holding companies consider any factors other than the six factors described above. The compensation committee charter must expressly address the obligation to conduct this independence assessment. For NASDAQ listed companies, these obligations would become effective on July 1, 2013, but amendments to the compensation committee charter would not be required until the earlier of the first annual meeting held after January 15, 2014, or October 31, 2014.

Recommendations

Each financial institution holding company should begin preparing for these new requirements by:

- Reviewing the composition of the compensation committee (if one exists) or beginning the process of establishing a compensation committee (for NASDAQ companies only).
- Updating or preparing a new compensation committee charter describing the minimum qualifications for service, including those relating to compensation committee independence.
- Updating or preparing a new compensation committee charter to ensure that the compensation committee has the ability to retain independent compensation advisers and which requires that the compensation committee conduct an independence assessment before engaging a compensation adviser.
- Updating or revising director and officer questionnaires to solicit information regarding any business or personal relationships with any individual compensation adviser or the person employing such individual.

- Begin preparing a form of compensation adviser questionnaire to solicit information from compensation advisers contemplated by the six-factor independence test described above.