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Compensation committee composition

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Independence requirements

The New York Stock Exchange ("NYSE") mandates that listed companies have a standing compensation committee composed of a majority of independent directors. Rule 10C-1 under the Securities Exchange Act of 1934, as amended (the "Exchange Act"), enhances this framework by providing guidance on determining committee member independence and the role of compensation consultants, legal counsel, and other advisors.

Requirements under Rule 10C-1 of the Exchange Act

Rule 10C-1 under the Exchange Act ("Rule 10C-1") directs national securities exchanges, including NYSE, to establish listing standards that require listed companies to have compensation committees. Key provisions include:

1. **Independence requirements:** requires listed companies to ensure that a majority of members of the compensation committee meet heightened independence criteria, including the source of compensation of the director and whether the director is an affiliate of the listed company.
2. **Authority to retain compensation advisors:** compensation committees of listed companies must have the sole authority to hire compensation consultants, independent legal counsel, or other adviser (collectively, "Compensation Advisors" and each a, "Compensation Advisor").
3. **Funding and oversight:** listed companies are required to reasonably fund the committee's Compensation Advisors, as determined by the compensation committee, to ensure that it can carry out its duties effectively.

4. **Advisor independence:** before engaging a Compensation Advisor, the compensation committee must assess the Compensation Advisor's independence using factors such as:
   - Provision of other services to the listed company.
   - Relationships between the advisor and members of management.
   - The advisor's financial ties to the listed company.

These rules provide a consistent framework for ensuring that compensation committees have the tools and independence needed to fulfill their fiduciary duties.

Independence standards

Section 303A.05 of the NYSE Listed Company Manual, together with Rule 10C-1, requires boards to evaluate and determine the independence of each compensation committee member, taking into account:

1. **Material relationships:** relationships with the company that would impair their independence, such as significant business or familial connections. A director would not be independent if the director (or an immediate family member) is currently or formerly employed by the company within the last three years.
2. **Sources of compensation:** a director's source of compensation, such as consulting or advisory fees from the company, that could compromise their ability to act independently. A director would not be independent, if within a 12-month period within the past 3 years, the director (or an immediate family member) has received $120,000 in direct compensation from the company (other than fees for serving as a director).
3. **Affiliation considerations:** affiliations with major shareholders, subsidiaries, or other entities related to the company to ensure objective decision-making; provided that stock ownership, even if significant, would not in and of itself negate a determination of independence.

These criteria are designed to help the board mitigate conflicts of interest and ensure that decisions regarding executive compensation are aligned with shareholder interests. Following review of the criteria, the board must affirmatively conclude that each director is able to be independent from management and can make reasoned independent decisions with respect to the company.

Other composition considerations

Non-employee directors for Section 16 purposes

In addition to independence requirements, an NYSE-listed company should consider the designation of its compensation committee members as "non-employee directors" under Rule 16b-3 under the Exchange Act ("Rule 16b-3"). See *Main responsibilities—Section 16 compensation matters*.

Role of Compensation Advisors

The role of Compensation Advisors is critical to ensuring fair and competitive executive compensation practices. Both Rule 10C-1 and NYSE listing rules emphasize the importance of advisor independence to avoid conflicts of interest.

NYSE rules empower compensation committees to:

- Retain their own Compensation Advisors.

- Require the listed company to provide appropriate funding for such Compensation Advisors' services.
- Assess Compensation Advisor independence using objective criteria.

This oversight ensures that the committee receives unbiased guidance, enabling it to design compensation packages that align with shareholder interests and regulatory requirements.

Main responsibilities

Fundamentals of the compensation committee charter

The compensation committee of an NYSE-listed company must be governed by a written charter that addresses the committee's:

- purpose and responsibilities—the compensation committee must have direct responsibility to: (i) review and approve corporate goals and objectives relevant to chief executive officer (CEO) compensation, evaluate the CEO's performance in light of those goals and objectives, and, either as a committee or together with other independent directors (as directed by the board), determine and approve the CEO's compensation level based on such evaluation, (ii) make recommendations to the board with respect to non-CEO executive compensation, and incentive-compensation and equity-based plans that are subject to board approval, and (iii) prepare the compensation committee report relating to the Compensation Discussion and Analysis ("CD&A") to be included in the company's annual report on Form 10-K, proxy statement on Schedule 14A or information statement on Schedule 14C pursuant to Item 407(e)(5) of Regulation S-K;
- annual evaluation of its performance; and
- rights and responsibilities, including as related to committee advisors.

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

A listed company must post its compensation committee charter, and the charter of any committee to which compensation committee functions have been delegated, on or through its website. It must also disclose in its annual proxy statement, or if it does not file an annual proxy statement, in its Form 10-K, that the compensation committee's charter is available on or through its website and provide the website address.

Section 16 compensation matters

Pursuant to Section 16(b) of the Exchange Act, any profits resulting from the trading of the company's equity securities within a period of less than 6 months (commonly referred to as short-swing profits) by reporting persons under Section 16 of the Exchange Act are recoverable by the company irrespective of any intention on the part of such Section 16 reporting person (the "Short-Swing Profit Rule").

Rule 16b-3 provides an exemption to the Short-Swing Profit Rule for executive officers and directors of the company. Under Rule 16b-3, a transaction between the company (including an employee benefit plan sponsored by the company) and an executive officer or director of the company that involves equity securities of the company shall be exempt from the Short-Swing Profit Rule if it satisfies certain conditions, including generally, if the transaction was approved in advance by the company's board or a committee thereof that is composed solely of two or more "non-employee directors."

A “non-employee director” is a director who: (i) is not an officer or employee of the company or a parent or subsidiary of the company, (ii) does not receive compensation in excess of $120,000, 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, and (iii) does not possess an interest in any transaction for which disclosure would be required as a “related party transaction” pursuant to Item 404(a) of Regulation S-K. The exemption provided by Rule 16b-3 is commonly used for equity-based awards, but it is also available, subject to the conditions specified in Rule 16b-3, for certain other transactions between the company (including an employee benefit plan sponsored by the company) and an executive officer or director of the company.

To the extent an NYSE-listed company wishes to rely on any corresponding exemption from the Short-Swing Profit Rule under Rule 16b-3, the company should (i) be prepared for its board to make approvals under the exemption, (ii) ensure that its compensation committee consists solely of two or more “non-employee directors” such that the compensation committee may make approvals under the exemption, or (iii) ensure that its board forms a special committee or compensation committee sub-committee that consists solely of two or more “non-employee directors” that may make approvals under the exemption.

Equity plan administration

A common function of the compensation committee is to oversee, or act as the administrator with respect to, a company’s equity compensation plan. In this role, the compensation committee often has all powers necessary to implement a company’s equity compensation program, including the powers to specify the terms of awards and approve awards, resolve all questions under the plans, and make all necessary determinations under the company’s plans.

The implementation of the company’s equity compensation program should follow the company’s specific business objectives. An evaluation of those objectives will guide the compensation committee’s approach to both forms of equity to be issued under a plan as well as the specific vesting criteria. Committees also may evaluate approaches of peer companies, in particular those peer companies that are in competition with the company for talent.

Recognizing that the compensation committee may meet quarterly, and there is a desire to provide equity incentives to new employees in connection with commencement of employment, a committee often will delegate limited powers to one of company’s officers to approve new hire equity compensation awards to non-Section 16 officers within tight confines specified by the committee, including a specified vesting schedule and a limit in the size of the award based on the position. As is discussed above, the committee usually retains authority for grants to Section 16 officers so that those grants qualify for an exemption from the Short-Swing Profit Rule.

CD&A proxy disclosure

The CD&A section of a company’s annual proxy provides the compensation committee an opportunity to explain the company’s compensation philosophy and to specifically comment on how the committee’s decisions with respect to named executive officer compensation align with that philosophy. Although there is no prescribed format, Item 402(b) of Regulation S-K sets forth a specific list of items that should be discussed (including objectives, compensation elements, and how amounts of each element are determined) and provides examples of items that may be relevant to include (such as policies for allocation between long-term and currently paid compensation, specific corporate objectives taken into account in setting compensation policies and making compensation decisions, and how specific forms of compensation are structured and implemented to reflect individual performance). However, at a high-level, and as is explained in the instructions to Item 402(b) of Regulation S-K, the "purpose of the CD&A is to provide to investors material information that is necessary to an understanding of the [company's] compensation policies and decisions regarding the named executive officers."

Certain meeting practices

Frequency

The compensation committee should meet regularly to fulfill its duties, with the frequency and intervals depending on the company's business, compensation arrangements and the scope of the compensation committee's responsibilities. Many committees hold regularly scheduled meetings on a quarterly basis and any ad hoc meetings on an as-needed basis. The company must disclose in its annual proxy statement the number of compensation committee meetings held during the prior fiscal year (along with certain enumerated information in Item 407 of Regulation S-K).

Meeting agendas and minutes

The compensation committee should set meeting agendas aligned with key milestones for each fiscal quarter or meeting period, as well as any strategic or business issues raised by the board or management. Agendas and meeting minutes help to ensure and memorialize that the committee remains focused on its responsibilities and strategic objectives.

Typical key agenda items throughout the company's fiscal year include, but are not limited to:

- approving remuneration budgets;
- evaluating executive performance and incentive-based compensation;
- reviewing compensation parameters, policies, benefits, and related plans;
- addressing promotions and new executive employment matters;
- approving the CD&A and proxy disclosures;
- assessing the company's peer group and benchmarking compensation;
- reviewing updates from advisors; and
- evaluating the committee's charter, performance, and advisor effectiveness.

Session participation

The compensation committee may include management in its meetings but should generally meet without management when evaluating executive performance or approving compensation matters.

Delegation of authority

If permitted by its charter and applicable laws and regulations, the compensation committee may delegate responsibilities to a subcommittee thereof, typically consisting of members of the compensation committee, and, in certain instances, to other directors, officers, or employees of the company. Delegated responsibilities should have clearly defined scopes, and the subcommittee, committee, or individuals to whom responsibility is delegated should provide regular and transparent updates to the compensation committee.

As noted above, to maintain the exemption under Rule 16b-3 to the Short-Swing Profit Rule, the compensation committee should not delegate the authority to grant awards, such as equity-based awards, to reporting persons under Section 16, to any person or other than to any committee or subcommittee that is composed solely of two or more "non-employee directors" of the company.

Considerations for foreign private issuers

Foreign private issuers ("FPIs") may choose to voluntarily adopt the same US corporate governance practices applicable to US domestic issuers, as discussed in the sections above. However, FPIs listed in the US benefit from flexibility in complying with such regulations of the Securities and Exchange Commission (the "SEC") and US stock exchange standards allowing them to follow home-country practices in key areas, such as those relating to compensation committee requirements and compensation disclosure. While less stringent in some areas compared to domestic issuers, FPIs must still provide certain threshold information to ensure transparency and enhance investor confidence.

NYSE standards relating to compensation committee requirements for FPIs provide the following relief:

Adherence to home country practices: FPIs may follow home-country corporate governance standards instead of US requirements. However, they must disclose significant differences in governance practices compared to US standards, either in their annual SEC filings (e.g. Form 20-F) or on their website.

Independence: unlike US companies, FPIs are not required to have a majority of independent directors or committees fully composed of independent directors. However, they must disclose which directors are independent and explain deviations from US practices.

In addition, and consistent with the less stringent compensation disclosure framework applicable to FPIs in connection with their ongoing reporting obligations (FPIs are not required to disclose individual compensation of executive officers to the same extent as US companies), the NYSE rules requiring companies to obtain shareholder approval for corporate actions, like equity compensation plans, substantial share issuances, or changes in control, are not applicable to FPIs.

Despite the general exemptions available to FPIs from numerous NYSE compensation committee governance requirements and the SEC's compensation disclosure obligations, recent SEC rules and NYSE standards on "clawbacks" impose a universal mandate. These rules require all issuers, including FPIs, to implement clawback policies, ensuring the recovery of erroneously awarded incentive-based compensation in the event of a financial restatement.

In light of recent regulatory changes, FPIs face heightened compliance challenges, particularly in areas related to compensation governance. To navigate these complexities effectively, FPIs should routinely assess their governance practices, align home-country requirements with US standards, and proactively address any gaps to ensure full compliance with applicable regulations.