



# DM Extra!

March 21, 2003

Timely Commentary on Critical Events and Regulatory Developments

## Director and Committee Independence, Plain and Simple: Revised Proposals from NYSE and Nasdaq Could Provide a Common Standard

### Director Summary >>

Are you an “independent” director? What about your key committees—are they “independent?” **Soon there may be new standards of independence** that allow directors to answer these questions more easily.

Until recently, it has been difficult if not impossible to give a simple answer to the question, “Are you independent?” Standards for director “independence” have varied depending on circumstances. Directors aiming to serve on public company compensation committees have been judged by one standard of independence,

while those wanting to serve on public company audit committees have been judged by another. And directors preparing to approve a stock transaction have had to meet another set of criteria entirely. Finally, directors wanting to meet the standards of particular constituencies have tried to meet those nonregulatory “best practice standards” published by a multitude of organizations, including the [NACD](#), [American Law Institute](#), [Business Roundtable](#), [Council of Institutional Investors](#), and [Institutional Shareholder Services](#).<sup>1</sup>

### Keep it Simple

“Keep it simple.” When it comes to independence, it can be hard to live up to this adage. A standard of independence that works in one context may not work in another.

This *DMX* outlines new standards that the [New York Stock Exchange](#) and [Nasdaq](#) have proposed for boards, and compares them to existing standards under federal securities laws and tax laws.

Directors can benefit from knowing the nuances of all these definitions, with their varying thresholds for dollars, for percentages of ownership, and for cooling-off periods. This knowledge can help directors form a positive defense against any accusation that this or that director lacked independence.

No doubt about it, the standards are complex. In explaining them, we have tried to make them as clear as possible. We have also expressed our belief that the standards could be heading toward greater uniformity, and, yes simplicity.

But for some boards, all this “greater clarity” and “greater simplicity” will not be good enough. They will want the clearest and simplest standard of all. For such boards, independent directors will have no connection other than their receipt of director fees. Period. And that—rather than conformity to less stringent standards—can make life simpler, and safer, for any board.

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- 1 For the full text of all these definitions, see [Director Professionalism—Report of the NACD Blue Ribbon Commission](#) (Washington, D.C., 2001), pp. 37-40.
- 2 The full text of the NYSE's filing is available at [www.nyse.com/pdfs/2003-06fil.pdf](http://www.nyse.com/pdfs/2003-06fil.pdf). The full text of Nasdaq's filing is available at [www.nasdaq.com/about/2002\\_141\\_A\\_1.pdf](http://www.nasdaq.com/about/2002_141_A_1.pdf).
- 3 The dates of these proposals were, respectively July 24, August 2, and September 13 of 2002. See past DMXs for details.
- 4 Only one other aspect of the governance packages has received such fast-track attention, namely the ones mandating shareholder approval of all stock-based compensation plans. That has already resulted in a final rule, as reported in *DMX* (October 25, 2002).
- 5 The strict standard used for the survey was the standard of the **Institutional Shareholder Services**, which states that the director must have "no connection to the company other than his or her board seat." It is similar to the standard the **NACD** has publicized for more than a decade.

Now simplification of independence standards is at hand. Although special standards will remain for public company audit committees (an issue unto itself, explored in the last section of this *DMX*), a newly revised **New York Stock Exchange (NYSE)** standard for director independence, along with a similar standard from **Nasdaq**, promises to become a virtually universal measurement for independence in other respects.<sup>2</sup>

This *DMX* analyzes the recently revised NYSE standards, compares them with existing standards, and explains how they are supplemented by a new **Securities and Exchange Commission (SEC)** rule pertaining to audit committee independence.

## Background

These "new" yardsticks have actually been in the making for a year now and will continue to take shape for months to come. Here is a quick chronology.

- Last year (March 2002), when **NACD President Roger Raber** presented 10 principles for corporate governance to **Congress, Nasdaq**, and the **NYSE** on behalf of the NACD board, his very first recommendation stated, "Boards should be comprised of a majority of independent directors." Other groups providing testimony made the same recommendation.
- Then, in a series of green lights (July, August, and September of 2002 respectively), the **Nasdaq**, **NYSE**, and **American Stock Exchange (Amex)** boards approved this principle as part of their larger packages (substantially similar) of rule proposals for the governance of listed companies.<sup>3</sup> The rule proposals for the NYSE included requirements that board audit, compensation, and governance committees all be composed entirely of independent directors.
- Last week (March 11 and March 12 of 2003), in response to an **SEC** request, the **Nasdaq** and **NYSE** sent in revised standards for *fast-tracking* purposes. Similar revisions from **Amex** could come soon. The fast-track treatment shows how important director independence is to the SEC.<sup>4</sup>

The revised stock listing proposals for independence, along with all the other governance proposals, could meet with **SEC** approval as early as June 2003, following rulemaking due process.

Are the new independence standards just another regulatory tempest in a teapot? We don't think so. For directors who have lived with a wide multiplicity of standards, the new standards, being all purpose (except for the higher standard applying to audit committees), provide welcome clarity. Until now, there has been no legal standard of independence for directors in general; only standards for particular director actions or roles. Many advocacy groups had proposed severe standards (e.g., no connection to the company other than a director seat), and these standards could have achieved some draconian simplicity, but none of these had the force of law.

## The Proposed NYSE Standard

The proposed **NYSE** standard promises to become a model not only for listed companies but also private companies seeking to emulate them. It is only a few paragraphs long, so we quote it verbatim (in bold):

### Section 303A (as proposed March 12, 2003):

#### 1. Listed companies must have a majority of independent directors.

This standard does not apply to the small number of NYSE-listed companies that are controlled by a single shareholder owning more than 50 percent of the stock. These companies must file for an exemption, and they still must have an independent audit committee (see p. 5).

**Likely trend:** Look for a *boom in director recruitment*. According to the most recent **NACD Public Company Survey**, only 61 percent of public companies (from a data base of the 5,000 largest public companies) have a majority of directors who meet a strict standard of independence. In these companies, more than 50 percent of directors have no connection to the company other than their board seats. This standard is somewhat stricter than the newly revised NYSE standard, which has a five-year cooling off period (as described below).<sup>5</sup> Nonetheless, it shows what a great need there will be for more independent directors. Note: The survey analyzes board independence in 25 industries. The industry with the highest prevalence of independent directors is the utilities sector, with 95 percent of boards meeting the majority independent standard. The industry with the lowest levels of independence is leisure services, where only 48 percent of boards have a majority of independent directors.

**Advice:** In the rush to meet this newly proposed requirement (defined further below), don't just settle for any candidate just because he or she is independent on paper. Rather, *focus on the strategic direction of the company* and recruit directors who can help the company achieve its goals.<sup>6</sup>

**2. In order to tighten the definition of "independent director" for purposes of these standards:**

- a. No director qualifies as "independent" unless the board of directors affirmatively determines that the director has no material relationship with the listed company (either directly or as a partner, shareholder, or officer of an organization that has a material relationship with the company). Companies must disclose these determinations.**

**Likely trend:** Boards will ask the company's general counsel and/or outside counsel to *evaluate the independence* of all current board members now deemed independent, and to review and update the board's policies pertaining to independence and conflicts of interest.

**Advice:** Again, don't let the desire for pure independence blind your board and governance/nominating committee to quality. *Consider each director as a unique case.* If a director fails the independence test on paper, yet has been a valuable board member, consider retaining him or her as an insider. Also, avail yourself of exemptions for this director if in good faith you believe that the relationships are not material.

**b. In addition:**

- i. A director who receives, or whose immediate family member receives, more than \$100,000 per year in direct compensation from the listed company . . . is presumed to be not independent.<sup>7</sup>**

This standard exempts board and committee fees. It also exempts deferred compensation not contingent on continued service. It has a five-year cooling-off period. (If a director has not received such compensation for five years, he or she may be considered independent.)

**Likely trend:** Unfortunately for the cause of independence, some boards *may continue paying directors as consultants*, limiting the amount to less than \$100,000. Worse yet, some boards, relieved to see this new "bright line" test, may begin using their directors as consultants, after having refrained from doing so earlier.

**Advice:** Avoid *retaining as a consultant* any director fulfilling the role of an independent outside director. Even at amounts under \$100,000, such a relationship is bound to rile shareholders, who for many years have held to a stricter standard of independence that would ban all such arrangements.

- ii. A director 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 auditor of the company is not "independent" until five years after the end of either the affiliation or the auditing relationship.**

The NYSE's letter does not explain what the exchange means by "affiliated" here. The SEC will probably apply (and include in the final rule) the same standard as the one proposed in the [SEC's final rule on independence of auditors, issued on January 28, 2003](#). Under this rule, a person is considered affiliated with an audit firm unless he or she has no influence on the accounting firm's operations or financial policies, no capital balances in that firm, and no financial arrangement with that firm other than one provided for regular payment of a fixed dollar amount (not based on revenues or profits of that firm) pursuant to a fully funded retirement plan or rabbi trust. By this definition, partners retired for more than five years from a firm that audited the company should be considered independent, but companies should ask the SEC for clarification on this point.

**Likely trend:** Combined with the new imperative to include an "audit committee financial expert"<sup>8</sup> on the audit committee, this newly proposed rule could lead boards to *reach out to new auditing firm alumni* as sources of retired partners. Long-retired partners of a company's audit firms may also be good candidates, as long as the SEC makes it clear in the final rules that such retired partners are not considered to be "affiliated."<sup>9</sup>

<sup>6</sup> For more guidance, see [The Role of the Board in Corporate Strategy—Report of the NACD Blue Ribbon Commission \(Washington, D.C.: NACD, 2000\)](#).

<sup>7</sup> The thresholds are lower than those in **Nasdaq's** current and proposed listing standards, which use 5% or \$200,000.

<sup>8</sup> In past releases on this topic, the **SEC** has emphasized the importance of avoiding the term "financial expert" for fear of running afoul of securities laws regulating the use of this term. Therefore, boards are advised to use this phrase in its entirety, even if it can sound redundant with the phrase "audit committee."

9 According to a comment letter from **C.H. Moore, Jr.**, CPA, dated January 23, 2003, the SEC needs to issue clarifying language on this point.

10 “Vice versa” is our shorthand for this repetitive language: “[company] for which the listed company accounts for at least 2 percent or \$1 million, whichever is greater, of such other company’s consolidated gross revenues.”

11 This language is summarized from Regulation S-K, Item 404, Item 404(a) and 404(b), which is incorporated by reference in the Rule 16b-3. For other definitions of “independence” under federal securities laws, see the *Securities Act of 1933*, Rule 144; and the *Securities Exchange Act of 1934*, Section 10A(m) and Rule 12b-2. For the full text of these definitions, visit [www.seclaw.com/secrules.htm](http://www.seclaw.com/secrules.htm).

**Advice:** When considering retired audit firm partners, be sure to ask what *involvement the individuals have had with governance*. All Big Four firms and many smaller firms have focused on governance in recent years, and it should be easy to identify the partners who have been involved with these efforts.

**iii. A director who is employed, or whose immediate family member is employed, as an executive officer of another company where any of the listed company’s present executives serves on that company’s compensation committee is not “independent” until five years after the end of such service or the employment relationship.**

**Likely trend:** Nominating/governance committees and executive recruiters will be more leery of including directors with *compensation committee interlocks*.

**Advice:** Remember that compensation committee interlocks are only one kind of possible “blinder” a director may have with respect to compensation. *Directors may have other ties to the CEOs* of the companies they serve. For example, they may belong to the same clubs. These interconnections may be benign, but in some cases they may compromise independence. That is why [thecorporatelibrary.com](http://thecorporatelibrary.com), a website of **Robert E. Monks** and **Nell Minow** (founder and first president of **Institutional Shareholder Services**, respectively), shows the links graphically (as lots of connecting lines). Most directors have many interlinks. Be alert to such ties—and stay tuned for our upcoming **NACD Blue Ribbon Commission** report on executive compensation and the role of the compensation committee.

**iv. A director who is an executive officer or an employee, or whose immediate family member is an executive officer, of another company (A) that accounts for at least 2 percent or \$1 million, whichever is greater, of the listed company’s consolidated gross revenues or (B) [vice versa]<sup>10</sup>, in each case is not “independent” until five years after falling below such threshold.**

**Likely trend:** Nominating/governance committees will *avoid recruiting employees of major customers or suppliers* (including advisors).

**Advice:** To stay in touch with the *views of customers and suppliers*, consider forming an advisory board or committee that includes these representatives.

How soon will these likely trends occur? Don’t hold your breath. The newly proposed standards will need to go through the **SEC** rulemaking process and will not be final until June 2003 or later. Listed companies will have 18 months to comply. Therefore, directors should also be aware of *existing standards*—so that they can oversee a smooth transition from the current to the future standards.

## The Status Quo: Existing Standards

As emphasized earlier, existing standards do not constitute a general standard of independence, but depend on circumstances, as described below in more detail.

In **approving a stock transaction** (a transaction involving the buying or selling stock), in order to be considered independent under federal securities laws (i.e., Rule 16b-3 of Section 16 of the *Securities and Exchange Act of 1934*), a director must be deemed a “non-employee director.” Such a director is one who:

- Is not currently an officer of the issuer or a parent or subsidiary of the issuer, or otherwise currently employed by the issuer or parent or subsidiary of the issuer.
- Does not receive compensation, either directly or indirectly, from the company or a parent or subsidiary of the company, for services rendered by the consultant or in any capacity other than as a director, except for an amount that does not exceed \$60,000.
- Does not own more than 10 percent of entity that receives more than 5 percent of its revenues or assets from the company.
- Does not serve the company as a lawyer or investment banker.<sup>11</sup>

*Comparison to proposed NYSE standard.* This standard is different from the standard proposed for **NYSE** corporate boards—and overall tougher. The dollar limit is more stringent

(\$60,000 vs. \$100,000) and the ownership threshold is different (10 percent ownership of a 5 percent-connected company, vs. officer status in a 2 percent-connected company). Pending revision of Rule 16b-3, directors should respect this definition when approving stock transactions.

In *approving a pay-for-performance plan*, in order to be considered independent under federal tax law, i.e., Section 162(m),<sup>12</sup> a director must also be deemed an outside director. Under this regulation, an outside director:

- Is not a current employee of the public corporation or its affiliates.
- Is not a former employee who receives compensation for previous services (other than from a tax-qualified retirement plan).
- Is not a current or former officer.
- Does not receive remuneration, either directly or indirectly, other than as a director. Disqualified remuneration is considered received if:
  - It goes to the director or to an entity in which the director has a beneficial ownership of over 50 percent.
  - It is paid to an entity in which the director is employed or self-employed, or in which the director has an interest of at least 5 percent but not more than 50 percent (excluding pay of up to \$60,000 per year).

*Comparison to proposed NYSE standard.* This current tax law standard is also different from the proposed NYSE standard. The dollar limit is \$60,000 vs. \$100,000, and the ownership threshold is different (disqualifying pay received from a majority-controlled company or a employee status, vs. officer status in a 2 percent-connected company). Pending revision of 162(m), boards should ensure that their compensation committee members meet this standard—even while preparing to meet the anticipated stock market standard.

In serving on an *audit committee of a company listed on the New York Stock Exchange* (under current NYSE Rule 303, which applies until the SEC approves the revised version) a director must be “independent of management and free from any *relationship* that, in the opinion of its board of directors, would interfere with the exercise of independent judgment as a committee member.”

In serving on the *audit committee of a company listed on the Nasdaq* (under Nasdaq Rule 4350(d)(2)(C) which is also still valid until changed), a director must be “a person other than an officer or employee of the company or its subsidiaries or another 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.”

Both exchanges define these relationships in detail, but these details will be superseded by April 26, 2003, because of a newly proposed final rule on audit committee independence, promulgated by the SEC implementing the **Public Accounting Reform and Investor Protection Act of 2002**, known as Sarbanes-Oxley after its cosponsors **Paul Sarbanes** (D-MD) and **Michael Oxley** (R-OH). A brief overview of this proposed rule appears immediately below.

## Audit Committees’ Higher Standard

As mentioned earlier, the NYSE proposals for listed company governance included a requirement that audit, compensation, and governance committees be composed of independent directors. This same requirement, with respect to audit committees, appeared in Section 301 of the Sarbanes-Oxley Act. This Act, signed into law July 30, 2002 (the day before the NYSE board approved the exchange’s governance package), states that listed companies must have audit committees composed entirely of independent directors. To be independent under this standard, an audit committee member must not accept any “consulting, advisory, or other compensatory fee” from the company, except for fees from board or committee service. Sarbanes-Oxley also states that audit committee members must not be “affiliated” with the company.

On January 8, 2003, the SEC proposed a rule on “[Standards Relating to Listed Company Audit Committees](#),” which is scheduled to become final no later than April 26. Under this proposed rule, audit committee members must not be affiliated either directly or indirectly through a spouse or an entity of which the person is a member, partner, or principal.<sup>13</sup> The proposed rule’s definition of “affiliated person” is consistent with current SEC definitions, including Rule 144 under

<sup>12</sup> Section 162(m), a tax provision enacted a decade ago, allows companies to deduct amounts paid over \$1 million only if the pay was awarded under an incentive plan approved by an independent compensation committee.

<sup>13</sup> Securities and Exchange Commission 17 CFR Parts 228, 229, 240, 249, and 274, Release Nos. 33-8173; 34-47137; IC-25885; File No. S7-02-03; RIN 3235-A175 Standards Relating to Listed Company Audit Committees.

<sup>14</sup> This definition includes a safe harbor similar to one proposed in 1997, namely that as long as a person is not an executive officer, director, or 10 percent shareholder, that person will not be deemed to control the issuer.

<sup>15</sup> See Section 10A(m) of the *Securities Exchange Act of 1934*. See also *Securities Exchange Act of 1934* Rule 12b-2 and *Securities Act of 1933* Rule 144.

<sup>16</sup> The SEC's proposed definition of affiliated person would "require a factual determination based on a consideration of all relevant facts and circumstances."

Note: NACD used only primary materials (Amex, Nasdaq, NYSE, and SEC documents) and NACD publications to prepare this DMX. We also acknowledge continuing helpful guidance from all the law firms associated with NACD, including notably:

[Gibson, Dunn & Crutcher LLP](#); [Jones Day](#); and [Weil, Gotshal & Manges LLP](#),

which have published especially useful letters on the topics discussed in this issue.

the Securities Act of 1933, which defines an "affiliate" of a company as "a person that directly, or indirectly through one or more intermediaries, controls, or is controlled by, or is under common control with" the company."<sup>14</sup>

The proposed requirements, says the SEC, will "enhance audit committee independence by implementing the two basic criteria for determining independence" under federal securities law.<sup>15</sup>

- First, audit committee members would be "barred from accepting any consulting, advisory, or other compensatory fee from the issuer or an affiliate of the issuer, other than in the member's capacity as a member of the board of directors and any board committee."
- Second, audit committee members (with exceptions for those serving investment companies) "may not be an affiliated person of the issuer or any subsidiary of the issuer apart from his or her capacity as a member of the board and any board committee."<sup>16</sup>

The SEC exempted from the independence requirements "particular relationships with respect to audit committee members, if appropriate in light of the circumstances." It also noted that, "Companies coming to market for the first time may face particular difficulty in recruiting members that meet the proposed independence requirements." Such companies may also need directors with "historical knowledge" of the company. For this reason, the SEC proposes to give

newly public companies a 90-day extension for compliance from the time of its initial registration for a public offering.

The comment period on this proposed rule on audit committee independence has expired. (on February 18, 2003), so the final SEC rule should appear soon. Stay tuned.

## The Bottom Line: True Independence

These new standards for director and audit committee independence may seem like just more red tape in an area already full of it. In truth, however, these new standards are likely to make it easier to determine independence, eventually replacing many of the standards now in use.

As such, directors should study these standards carefully and use them as a minimum standard for independence. More stringent standards may be necessary in particular circumstances.

The main point in all of this is to ensure that the board exercises independent oversight of management. This independent oversight lies at the very heart of the so-called "corporate governance revolution" that began a quarter century ago when NACD was founded. It has only gained in importance since then. To achieve this goal, directors must be independent not only on paper, but also in fact. Only well-informed and well-intentioned boards can achieve both goals.

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