Celebrating 40 Years of Progress

Nov. 5, 2012

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Re: SEC Rule 10C-1--Listing Standards for Compensation Committees

Dear Officers,

On behalf of more than 300,000 Public Citizen members and supporters, we write to comment on the proposed amendments to comply with the Securities and Exchange Commission ("Commission" or "SEC") Rule10C-1, which implements Section 952 from the Dodd-Frank Wall Street Reform Act. .

In summary, we believe the self-regulatory organizations (SROs) and the SEC have failed to honor the intent of Congress's mandate that compensation committees be composed of directors who are "independent" as a means to reform excessive pay and misaligned compensation incentives. Instead, the SEC and SROs have essentially restated existing standards that clearly haven't succeeded in reforming compensation. True board independence will be evident when CEO pay declines; such independence will require ambitious reforms well beyond the status quo.

Unjustifiable Pay Results from Governance Dysfunction

By any measure, CEOs of major corporations are overpaid. According to the AFL-CIO's authoritative annual Executive Paywatch review, the ratio of CEO-to-worker pay at the 500 largest companies grew to 380 times in 2011. In 1980, that figure was 42 times.[1] It is inconceivable that shareholders content with a pay ratio of 42 in 1980 are *happier* with today's ratio of 380.

[1] "Executive Paywatch, available at http://www.aflcio.org/Corporate-Watch/CEO-Pay-and-the-99/Trends-in-CEO-Pay

High pay with misaligned incentives figured at the center of the financial crash. The Federal Reserve found that "risk-taking incentives provided by incentive compensation arrangements in the financial services industry were a contributing factor to the financial crisis that began in 2007."[2] Even senior executives of failed firms such as Bear Stearns and Lehman Brothers walked away from the wreckage they created with many millions of dollars in pay, with these executives pocketing $2.4 billion from 2000-2008.[3] Lehman CEO Richard Fund may have suffered a damaged reputation. He may even have lost some of the value of his portfolio holding in Lehman stock. But he did not become destitute, as did millions of Americans as a result of Wall Street recklessness. On the contrary, he became rich. It is inconceivable that shareholders who lost most or all of their investment value in Bear and Lehman are content that they collectively paid senior executives $2.4 billion for patent mismanagement.

The Dodd-Frank Wall Street Reform Act constituted a necessary response to these harsh lessons of the financial crisis.

Dysfunctions within corporate governance enable excessive CEO pay at financial firms and other public companies. Directors aren't truly accountable to shareholders. Conflicts abound. The inexorable escalation of CEO pay with little or no connection to the promotion of long term stability of the enterprise attests to the fact that directors are failing. Directors are failing to say "no" to higher pay. And one reason they fail to say "no," according to experts, is because they are compromised. They are not truly independent.[4]

In partial repair of this dysfunction, Congress included Section 952 in the Wall Street Reform Act. This states clearly and unequivocally that "each member of the compensation committee of the board of directors . . . be . . . independent."

The congressional mandate mandate for director independence in Dodd-Frank is clear and unambiguous. Congress provided no exemptions, no de minimis outside consulting compensation that it would countenance, and no accommodation for minor conflicts.

What conflicts compromise independence? Directors who are not independent include those with clear ties to the company. Most obvious are the directors who are also employees of the company. A board director who can lose his day job if the CEO fires him is hardly likely to object to the CEO's pay package.[13] Also well recognized as not independent are directors who are executives of other companies. "Boards sometimes included CEOs from other companies, who were eager to raise the bar so they could

[2] "Federal Reserve: Incentive Compensation Practices: A Report on the Horizontal Review of Practices at Large Banking Organizations, October 2011, available at http://www.federalreserve.gov/publications/other-reports/files/incentive-compensation-practices-report-201110.pdf

[3] "The Wages of Failure: Executive Compensation at Bear Stearns and Lehman 2000-2008" by Lucian Bebchuk et al, Yale Journal on Regulation, available at: http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1513522

[4] "MF Board Seen Beholden to Corzine as Risk Grew," by Joseph Giannone et al, Nov. 4, 2011, available at http://www.reuters.com/article/2011/11/04/us-mfglobal-governance-newspro-idUSTRE7A32FU20111104

[13] Robert Boothby, a former Conservative member of Parliament, described in a speech what board service was like in that era: "No effort of any kind is called for. You go to a meeting once a month, in a car supplied by the company. You look grave and sage, on two occasions say 'I agree,' say 'I don't think so' once, and if all goes well you get 500 pounds a year." He added, "If you have five of them, it is total heaven, like having a permanent hot bath." "Independent Chairmen are Smart Investments," by Nell Minow, http://www.bloomberg.com/news/2012-07-17/independent-chairmen-are-smart-investments-nell-minow.html

demand the same at their own firm," observes corporate governance expert Nell Minow. "Something like the Lake Wobegon effect took place: In measuring performance, all CEOs were above average."[14]

Director independence may be challenged for less obvious conflicts, such as contributions to a philanthropy with which the director is affiliated, funding for research the director conducts in his capacity as a professor, or director fees that are substantially greater than the director's non-director compensation.

- JP Morgan director Ellen V. Futter is president of the American Museum of Natural History in New York. JP Morgan CEO Jamie Dimon contributes to the museum. Futter also sits on the bank's risk committee, which failed to prevent the firm's now acknowledged mistake in risk management, leading to a loss of more than $5 billion in its London office.[15]
- Chesapeake Energy board members awarded high compensation to CEO Aubrey McClendon and failed to bridle his outside hedge fund activity. One of these board members was V. Burns Hargis, President of Oklahoma State University, which received at least $2 million in commitments and donations from Chesapeake in 2011. Leading shareholders protested Hargis' role on the board, and he resigned last year. [16][17]
- The Disney board once included a director named Riveta Bowers who was the principal of the elementary school attended by children of the Disney CEO. Her compensation as a director figured as a significant part of her total compensation. Observed one legal scholar, "Bowers had a lot to lose and little to gain by crossing [the CEO]." [18]Following litigation by plaintiffs arguing that the board overpaid the CEO, shareholder dissent, and media attention, this director did not stand for re-election.
- Exxon's board includes Stanford professor Michael Boskin. [19][20] Exxon and other energy firms contributed $225 million to Stanford in 2002 for research.[21]

How independence should be understood

Board directors who consider that a CEO has performed below expectations should feel free to decide to cut compensation. Since, arithmetically, half of all CEOs perform below average, whether measured against all companies or even among peers, compensation committees should respond accordingly. A director should not calculate that he or she might lose income or other benefits from opposing CEO pay because there must be nothing to gain by compromising independence.

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[14] "Executive Decisions," by Nell Minow, The New Republic," Feb 8, 2011, available at http://www.tnr.com/article/magazine/100519/ceo-bonus-inequality-securities-crisis-severance
[15] JP Morgan website, http://www.jpmorganchase.com/corporate/About-JPMC/board-of-directors.htm
[16] "Changes as Chesapeake," August 9, 2012, at Glass Lewis website, available at: http://www.glasslewis.com/blog/changes-at-chesapeake/
[17] "Shareholders Rebuke Chesapeake Leadership," by Clifford Krauss, New York Times, June 8, 2012, available at http://www.nytimes.com/2012/06/09/business/shareholders-reject-chesapeake-directors.html?_r=0
[18] "Director Independence and the Duty of Loyalty," by Larry Backer, St John's Law Review, fall, 2005, http://scholarship.law.stjohns.edu/cgi/viewcontent.cgi?article=1257&context=lawreview
[19] ExxonMobil website, http://www.exxonmobil.com/Corporate/investor_governance_directors.aspx
[20] ExxonMobil website, http://www.exxonmobil.com/Corporate/investor_governance_comm.aspx
[21] Stanford's Deal with Exxon Mobil Raised Concerns," by Jennifer Washburn, New America Foundation, April 8, 2007, published in Sacramento Bee, available at: http://www.newamerica.net/publications/articles/2007/stanfords_deal_with_exxon_mobil_raised_concerns_5137

A director laboring under any of these compromising circumstances cannot be considered independent. Under Section 952, they cannot serve on the compensation committee.

What the SEC and SROs Propose

In directing the exchanges to adopt rules, the SEC required "the exchanges to consider relevant factors including, <u>but not limited to:</u> (i) the source of the director's compensation, including any consulting, advisory or other compensatory fees paid by the listed company; and (ii) whether the director has an affiliate relationship with the company, a subsidiary of the company or an affiliate of a subsidiary of the company.

NASDAQ recognizes that "responsibility for executive compensation decisions is one of the most important responsibilities entrusted to a board of directors." We are pleased that NASDAQ has joined the NYSE in requiring that all listed companies have a standing compensation committee of independent directors, consisting of at least two members. [22]

When retaining compensation consultants, the proposed SRO rules require the compensation committee to consider what other services the consultant provides to the company, the amount of fees for these other services, and any business or personal relationship between the consultant and executives whose pay the compensation committee directors will determine. We are discouraged that the NYSE only directs that these conflicts be considered, and draws no bright lines for how these conflicts should be addressed.

We support the directive from the SEC and exchanges "that no director qualifies as "independent" unless the board of directors affirmatively determines that the director has no material relationship with the listed company."

We fully support NASDAQ's prohibition on all consulting, advisory or other compensatory fees from the company beyond the director fee. Any such fee can compromise independence. Conversely, we emphatically oppose the NYSE's tolerance of consulting fees up to $120,000 for directors the exchange will nevertheless consider independent. The NYSE offers no justification for such tolerance because, obviously, no justification is available.

Most troubling, both exchanges have ignored the powers offered by the SEC in its invitation that the relevant factors that determine independence are "not limited to" consulting fees or affiliate relationships. In fact, the NYSE confesses that it "does not propose to adopt any specific numeral tests … or to adopt a requirement to consider any other specific factors." In other words, business as usual. Congress approved Section 952 as a vehicle for reform. Had Congress viewed there to be no problems with director independence in deciding executive compensation, it would not have troubled itself to approve a statute. The SEC and SROs have effectively ignored the clear mandate of Congress.

What the exchanges should do to establish independence of directors

Establishing true director independence will require ambitious reforms.

[22] SEC Release, Oct. 9, 2012, available at http://www.sec.gov/rules/sro/nasdaq/2012/34-68013.pdf

1. Require that the board publish a fulsome discussion of how the board affirmatively decides a director is independent. This discussion should even include evidence of conflicts that the board dismisses as immaterial. For example, if the JP Morgan board considers CEO Jamie Dimon's contributions to Ellen Futter's museum is immaterial, such a statement should be published, noting the dollar value of that contribution, and why the board considers this immaterial. We support NASDAQ's acknowledgement that at charitable contributions may disqualify a director as independent, although we believe the level should below the exchanges proposal, which is the greater of $200,000 or 5 percent of the charity's annual revenue.

2. Count compensation received as director as a test of independence. Even the NYSE recognizes that more than $120,000 in compensation beyond director fees compromises independence. If, in its wisdom, the SRO considers this figure as pivotal, then such remuneration should also apply to the director fee. Any director fee beyond $120,000 should disqualify a director as independent. "Let's face facts," said Michelle Leder, the editor of Footnoted.org, a corporate watchdog web site. "If you had a part-time job that was paying you $300,000, $400,000, $500,000 a year, and you didn't have a lot of work to do, would you rock that boat? That's just human nature."[23][24] At Chesapeake Energy, the New York Times noted that CEO Aubrey "Mr. McClendon's handpicked board was widely viewed as little more than a rubber stamp whose members were kept satisfied by rich compensation and generous perks like the use of company aircraft." [25]

3. Ideally, directors should be paid for actual effort, such as through hourly rates. Directors who apply more diligence through study of company reports our outside information should be paid more than those who come unprepared to a meeting. A 200/hr rate translates into $400,000 a year, a handsome figure by any measure. The average director who attends 12 board meetings a year, or 12 full days, and prepares for an additional 36 days, or 3 full days for each meeting, would receive $76,000. This, too, is generous compensation. Universities, philanthropies, and private sector firms are brimming with capable candidates who would certainly serve for this sum.

4. Personal relationships must be barred. Independent compensation committee members cannot be the CEO's college roommate, fraternity brother, golfing buddy or bridge partner. Short of director functions, compensation committee members should not socialize privately with the CEO. The same stern level of scrutiny as in any labor-management negotiation should prevail as the independent compensation committee members determine CEO pay. Ideally, compensation committee members will not even be friends of friends of the CEO.

[23] "Director's Cut," by Steve Eder, Dec. 16, 2009, available at: http://www.reuters.com/article/2009/12/16/us-boardpay-idUSTRE5BF4TT20091216

[24] See also the compensation of Chesapeake Energy directors, at http://seekingalpha.com/article/556031-a-look-at-chesapeake-energy-s-board-of-directors-compensation

[25] "Shareholders Rebuke Chesapeake Leadership," by Clifford Krauss, New York Times, June 8, 2012, available at http://www.nytimes.com/2012/06/09/business/shareholders-reject-chesapeake-directors.html?_r=0

The Council of Institutional Investors,[27] whose members include pension funds and other institutional investors with combined assets exceeding $3 trillion, states that "most simply, an independent director is a person whose directorship constitutes his or her only connection to the corporation."[28] Achieving this standard will certainly require more than the SROs' minimalist approach to implementation of the Dodd-Frank Section 952 mandate that compensation committee directors be independent. Without stricter standards, American shareholders will remain ill-served; CEO pay will gouge ever larger and unjustifiable portions of shareholder value.

We are happy to discuss these ideas further, and can be contacted at bnaylor@citizen.org, or at 202.580.5626. Your consideration is appreciated,

Sincerely,

Bartlett Naylor
Financial Policy Advocate
Public Citizen's Congress Watch.

[27] Council of Institutional Investors, http://www.cii.org/about
[28] Council policies, available at http://www.cii.org/policies