Council of Institutional Investors
The Voice of Corporate Governance

Via Email

November 1, 2012

Ms. Elizabeth M. Murphy
Securities and Exchange Commission
101 F Street, NE
Washington, DC 20549-1090

Re: File Number SR-NYSEArca-2012-105[1]

Dear Ms. Murphy:

I am writing on behalf of the Council of Institutional Investors ("Council"), a non-profit association of corporate, public and union employee benefit plans with combined assets in excess of $ 3 trillion.[2] Council members are large, long-term shareowners responsible for safeguarding the retirement savings of millions of American workers. The purpose of this letter is to respond to your "notice to solicit comments" on the NYSE Arca, Inc. ("NYSE") proposed rule change to modify the NYSE Equities Rulebook to comply with the requirements of the Securities and Exchange Commission ("Commission") Rule 10C-1 ("Proposed Rule").[3]

At the outset, we note that the Financial Crisis Inquiry Commission ("FCIC") concluded:

> Compensation systems—designed in an environment of cheap money, intense competition, and light regulation—too often rewarded the quick deal, the short-term gain—without proper consideration of long-term consequences. Often, those systems encouraged the big bet—where the payoff on the upside could be huge and the downside limited. This was the case up and down the line—from the corporate boardroom to the mortgage broker on the street.[4]

[1] Notice of Filing of Proposed Rule Change Amending NYSE Arca Equities Rule 5.3(k)(4) to Comply with the Requirements of Securities and Exchange Commission Rule 10C-1, Exchange Act Release No. 68,006 (Oct. 9, 2012), http://www.sec.gov/rules/sro/nysearca/2012/34-68006.pdf [hereinafter Proposed Rule].
[2] For more information about the Council of Institutional Investors (Council) and its members, please visit the Council's website at http://www.cii.org/become_a_member/become_a_member.
[3] Proposed Rule, *supra* note 1, at 1; 2.
[4] The Financial Crisis Inquiry Report *xix* (Jan. 2011), http://fcic-static.law.stanford.edu/cdn_media/fcic-reports/fcic_final_report_full.pdf.

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Significant responsibility for the faulty compensation systems identified by the FCIC resides with compensation committees that approved, sometimes following the recommendations of conflicted external advisers, poorly structured pay packages that encouraged a get-rich-quick mentality and overly risky behavior that helped bring the capital markets to their knees.[5] We, therefore, generally supported Section 952 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 ("Dodd-Frank") which is the statutory authority for the Proposed Rule.[6]

Our support for Section 952 of Dodd-Frank was derived from the Council's membership approved policies which include a number of substantive provisions on "principles and practices for compensation committees,"[7] and, importantly, a detailed "independent director definition."[8] Combined those policies support fully-independent compensation committees to help ensure that executive pay decision-making is free of actual or perceived conflicts of interest that could color committee members' judgment.[9] Those policies also support the concept of minimizing and disclosing potential conflicts of interest among pay advisers.[10] In our view, pay advisers who, for example, count on lucrative actuarial or employee benefit contracts from senior management may be inclined to recommend overly-generous pay packages for those executives.[11]

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[5] Letter from Justin Levis, Senior Research Associate, Council of Institutional Investors to Ms. Elizabeth Murphy, Secretary, U.S. Securities and Exchange Commission 1 (Apr. 20, 2011) (Commenting on the U.S. Securities and Exchange Commission proposal that resulted in Rule 10C-1 implementing Section 952 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank)), http://www.cii.org/UserFiles/file/CII%20Letter%20on%20SEC%20Proposal%20on%20Comp%20Cmtes%20final.pdf.

[6] S*ee, e.g.,* Letter from Jeff Mahoney, General Counsel, Council of Institutional Investors to The Honorable Christopher J. Dodd, Chairman, Senate Committee on Banking, Housing, and Urban Affairs 2 (Nov. 18, 2009) ("Reforms included in the discussion draft [the predecessor to Section 952 of Dodd-Frank] would help ensure that compensation committees are free of conflicts and receive unbiased advice."), http://www.cii.org/UserFiles/file/Dodd%20Reform%20Bill%20Discussion%20Draft%20Letter%2011-18-09.pdf.

[7] Council of Institutional Investors, Corporate Governance Policies **§ 5.5 Role of Compensation Committee** (updated Oct. 5, 2012), http://www.cii.org/UserFiles/CII%20Corp%20Gov%20Policies%20Full%20and%20Current%2010-5-12%20FINAL(2).pdf.

[8] *Id.* **§ 7 Independent Director Definition**.

[9] *See id.* **§ 5.5a Committee Composition** ("All members of the compensation committee should be independent.").

[10] *Id.* **§ 5.5g Outside Advice** ("the committee should annually disclose an assessment of its advisers' independence, along with a description of the nature and dollar amounts of services commissioned from the advisers and their firms by the client company's management"); *see also* Investors' Working Group, U.S. Financial Regulatory Reform: The Investors' Perspective 23 (July 2009), http://www.cii.org/UserFiles/file/resource%20center/investment%20issues/Investors'%20Working%20Group%20Report%20(July%202009).pdf (findings endorsed by Council membership include that "[c]onflicts of interest [of compensation advisers] contribute to a ratcheting-up effect for executive pay . . . [and] should be minimized and disclosed").

[11] *See, e.g.,* Investors' Working Group at 23.

Consistent with the Council's membership approved policies, the Council provides the following specific comments on the Proposed Rule:

Compensation Committee Director Independence

The Council generally supports the Proposed Rule's amendment to NYSE Equities Rule 5.3(k)(4) to require:

> [I]n affirmatively determining the independence of any director who will serve on the compensation committee of the listed company's board of directors, the board of directors must consider all factors specifically relevant to determining whether a director has a relationship to the listed company which is material to that director's ability to be independent from management, in connection with the duties of a compensation committee member including, but not limited to, the two factors that are set forth in proposed NYSE Arca Equities Rule 5.3(k)(4) and are explicitly enumerated in Rule 10C-1(b)(ii).[12]

We, however, would respectfully request that when considering the independence of any director who will serve on the compensation committee the final rule explicitly require the board to consider one additional factor—the "personal or business relationships between members of the compensation committee and the listed issuer's executive officers."[13] As suggested by the Commission in promulgating Rule 10C-1,[14]we believe that personal or business relationships between the director who will serve on the compensation committee and the issuer's executive officers are not uncommon and can result in the loss of the director's independence.[15]

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[12] Proposed Rule, *supra* note 1, at 5.
[13] Listing Standards for Compensation Committees, Exchange Act Release No. 67,220, at 24 (June 20, 2012), http://www.sec.gov/rules/final/2012/33-9330.pdf.
[14] *Id.* ("the exchanges might consider that personal or business relationships between members of the compensation committee and the listed issuer's executive officers should be addressed in the definition of independence").
[15] Listing Standards for Compensation Committees, Exchange Act Release No. 67,220, at 24 (June 20, 2012), http://www.sec.gov/rules/final/2012/33-9330.pdf.

As explained in our comment letter to the Commission in response to the promulgation of Rule 10C-1:

> A director may lose objectivity in his/her oversight role if he/she, for instance, is associated with a firm that is a paid adviser to one of the company's *executive officers* or if he/she is associated with a non-profit organization that receives significant grants from one of the *company's officers.* Other examples include if the director is part of an interlocking directorate in which the *CEO or other officer of the company* serves on the board of a third-party entity (for-profit or not-for-profit) employing the director, or if the director delegates his/her decision making power as a director to *management*.[16]

While we acknowledge that the NYSE believes that it "interprets its existing director independence requirements as requiring the board to consider relationships between the director and any member of management in making its affirmative independence determinations," in our view, the importance of this factor requires that it be explicitly referenced in the final rule.[17] Longer term, we would respectfully request that the NYSE consider, perhaps as part of a future rulemaking, developing a more comprehensive and robust definition of an independent director that would be applicable to *all* board committees consistent with the best practices reflected in the Council's membership approved policies. To assist you in that regard attached to this letter for your consideration is the entire Council membership approved "Independent Director Definition."

Compensation Adviser Independence Factors

We generally support the Proposed Rule's requirement that "before engaging an adviser, the compensation committee must consider" the six independence factors enumerated by Rule 10C-1(b)(4).[18] We, however, would respectfully request that one additional factor be added to the list when determining an adviser's independence—whether the compensation committee consultants, legal counsel, or other advisers require that their clients contractually agree to indemnify or limit their liability.

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[16] Letter from Justin Levis at 3 (emphasis added).
[17] Proposed Rule, *supra* note 1, at 16.
[18] *Id.* at 8.

We note that it has become standard practice for many compensation consultants to include third party indemnification and limitation of liability clauses in contracts with their corporate clients. Consistent with Council membership approved policies, we believe that those contractual provisions raise conflict of interest red flags that every compensation committee should consider as a factor in determining the independence of a consultant.[19] In our view, compensation advisers and their firms should stand behind their work and buy insurance coverage if concerned about potential liability.

We appreciate the opportunity to respond to the Proposed Rule. If you have any questions about this letter or need any additional information, please feel free to contact me at (or

Sincerely,

Jeff Mahoney
General Counsel

Attachment

[19] Council of Institutional Investors **§ 5.5g Outside Advice** ("Companies should not agree to indemnify or limit the liability of compensation advisers or the advisers' firms.").

Corporate Governance Policies[1]

7. Independent Director Definition

7.1 Introduction
7.2 Basic Definition of an Independent Director
7.3 Guidelines for Assessing Director Independence

7.1 Introduction: A narrowly drawn definition of an independent director (coupled with a policy specifying that at least two-thirds of board members and all members of the audit, compensation and nominating committees should meet this standard) is in the corporation's and shareowners' financial interest because:

- Independence is critical to a properly functioning board;
- Certain clearly definable relationships pose a threat to a director's unqualified independence;
- The effect of a conflict of interest on an individual director is likely to be almost impossible to detect, either by shareowners or other board members; and
- While an across-the-board application of *any* definition to a large number of people will inevitably miscategorize a few of them, this risk is sufficiently small and is far outweighed by the significant benefits.

Independent directors do not invariably share a single set of qualities that are not shared by non-independent directors. Consequently no clear rule can unerringly describe and distinguish independent directors. However, the independence of the director depends on all relationships the director has, including relationships between directors, that may compromise the director's objectivity and loyalty to shareowners. Directors have an obligation to consider all relevant facts and circumstances to determine whether a director should be considered independent.

[1] To review the complete set of Corporate Governance Policies of the Council of Institutional Investors (Council), please visit the Council's website at http://www.cii.org/UserFiles/CII%20Corp%20Gov%20Policies%20Full%20and%20Current%2010-5-12%20FINAL(2).pdf.

7.2 Basic Definition of an Independent Director: An independent director is someone whose only nontrivial professional, familial or financial connection to the corporation, its chairman, CEO or any other executive officer is his or her directorship. Stated most simply, an independent director is a person whose directorship constitutes his or her only connection to the corporation.

7.3 Guidelines for Assessing Director Independence: The notes that follow are supplied to give added clarity and guidance in interpreting the specified relationships. A director will not be considered independent if he or she:

7.3a Is, or in the past five years has been, or whose relative is, or in the past five years has been, employed by the corporation or employed by or a director of an affiliate;

NOTES: An "affiliate" relationship is established if one entity either alone or pursuant to an arrangement with one or more other persons, owns or has the power to vote more than 20 percent of the equity interest in another, unless some other person, either alone or pursuant to an arrangement with one or more other persons, owns or has the power to vote a greater percentage of the equity interest. For these purposes, joint venture partners and general partners meet the definition of an affiliate, and officers and employees of joint venture enterprises and general partners are considered affiliated. A subsidiary is an affiliate if it is at least 20 percent owned by the corporation.

Affiliates include predecessor companies. A "predecessor" is an entity that within the last five years was party to a "merger of equals" with the corporation or represented more than 50 percent of the corporation's sales or assets when such predecessor became part of the corporation.

"Relatives" include spouses, parents, children, step-children, siblings, mothers and fathers-in-law, sons and daughters-in-law, brothers and sisters-in-law, aunts, uncles, nieces, nephews and first cousins, and anyone sharing the director's home.

7.3b Is, or in the past five years has been, or whose relative is, or in the past five years has been, an employee, director or greater-than-20-percent owner of a firm that is one of the corporation's or its affiliate's paid advisers or consultants or that receives revenue of at least $50,000 for being a paid adviser or consultant to an executive officer of the corporation;

NOTES: Advisers or consultants include, but are not limited to, law firms, auditors, accountants, insurance companies and commercial/investment banks. For purposes of this definition, an individual serving "of counsel" to a firm will be considered an employee of that firm.

The term "executive officer" includes the chief executive, operating, financial, legal and accounting officers of a company. This includes the president, treasurer, secretary, controller and any vice-president who is in charge of a principal business unit, division or function (such as sales, administration or finance) or performs a major policymaking function for the corporation.

7.3c Is, or in the past five years has been, or whose relative is, or in the past five years has been, employed by or has had a five percent or greater ownership interest in a third-party that provides payments to or receives payments from the corporation and either:

(i) such payments account for one percent of the third-party's or one percent of the corporation's consolidated gross revenues in any single fiscal year; or (ii) if the third-party is a debtor or creditor of the corporation and the amount owed exceeds one percent of the corporation's or third party's assets. Ownership means beneficial or record ownership, not custodial ownership;

7.3d Has, or in the past five years has had, or whose relative has paid or received more than $50,000 in the past five years under, a personal contract with the corporation, an executive officer or any affiliate of the corporation;

NOTES: Council members believe that even small personal contracts, no matter how formulated, can threaten a director's complete independence. This includes any arrangement under which the director borrows or lends money to the corporation at rates better (for the director) than those available to normal customers—even if no other services from the director are specified in connection with this relationship;

7.3e Is, or in the past five years has been, or whose relative is, or in the past five years has been, an employee or director of a foundation, university or other non-profit organization that receives significant grants or endowments from the corporation, one of its affiliates or its executive officers or has been a *direct* beneficiary of *any* donations to such an organization;

NOTES: A "significant grant or endowment" is the lesser of $100,000 or one percent of total annual donations received by the organization.

7.3f Is, or in the past five years has been, or whose relative is, or in the past five years has been, part of an interlocking directorate in which the CEO or other employee of the corporation serves on the board of a third-party entity (for-profit or not-for-profit) employing the director or such relative;

7.3g Has a relative who is, or in the past five years has been, an employee, a director or a five percent or greater owner of a third-party entity that is a significant competitor of the corporation; or

7.3h Is a party to a voting trust, agreement or proxy giving his/her decision making power as a director to management except to the extent there is a fully disclosed and narrow voting arrangement such as those which are customary between venture capitalists and management regarding the venture capitalists' board seats.

The foregoing describes relationships between directors and the corporation. The Council also believes that it is important to discuss relationships between directors on the same board which may threaten either director's independence. A director's objectivity as to the best interests of the shareowners is of utmost importance and connections between directors outside the corporation may threaten such objectivity and promote inappropriate voting blocks. As a result, directors must evaluate all of their relationships with each other to determine whether the director is deemed independent. The board of directors shall investigate and evaluate such relationships using the care, skill, prudence and diligence that a prudent person acting in a like capacity would use.

(Corporate Governance Policies last updated Oct. 5, 2012)