September 28, 2012

NYSE and Nasdaq Propose Compensation Committee Rules

Earlier this week, both the NYSE and Nasdaq submitted proposed rules to the Securities and Exchange Commission (SEC) setting forth the factors that they will use to determine independence for compensation committee members and compensation advisers. The proposed rules were required by SEC Rule 10C-1, which directed the securities exchanges to adopt rules requiring compliance with:

- compensation committee member independence standards, and
- rules requiring a review of the independence of certain compensation advisers retained by a compensation committee

as conditions to the listing of a company's equity securities. SEC Rule 10C-1 did not require a uniform definition of "independence." Instead, it permitted the securities exchanges to establish their own standards for independence based on relevant factors. See DP Alert dated June 22, 2012.

The following is a summary of the proposed rules.

NYSE Proposed Rules on Independence of Compensation Committee Members

The NYSE's director independence standards are set forth in Section 303A.02 of its Listed Company Manual. Section 303A.02(a) currently provides that no director is independent unless the board of directors affirmatively determines that he or she has no material relationship with the listed company (directly or as a partner, shareholder or officer of an entity that has a relationship with the listed company). In addition, Section 303A.02(b) currently provides that a director may not be deemed to be independent if he or she has a relationship with the listed company that violates any one of five "bright line" tests. [1]

The NYSE is not proposing any changes to the "bright line" tests set forth in Section 303A.02(b), which will continue to be used to determine the independence of compensation committee members. The NYSE is proposing, however, to expand Section 303A.02(a) to provide that in affirmatively determining the independence of a compensation committee member, the board of directors must consider all factors specifically relevant to determining whether a director has a relationship to the listed company that is material to his or her ability to be independent with management in connection with his or her duties as a compensation committee member, including but not limited to:

- The director's source of compensation, including any consulting, advisory or compensatory fee paid by the listed company; and
- 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.

The two above factors were explicitly enumerated in SEC Rule 10C-1.

In its proposed rule filing, the NYSE stated that compensation committee members can be deemed independent even if they own stock in the listed company. The NYSE said that it "does not view the ownership of even a significant amount of stock, by itself, as a bar to an independence find." It further stated that "share ownership in the listed company aligns the director's interests with those of unaffiliated shareholders, as their stock ownership gives them the same economic interest in ensuring that the listed company's executive compensation is not excessive."

The receipt of director fees for service on a board will also not preclude a director from being deemed independent for purposes of serving on the compensation committee.[2]

Listed companies would have until the earlier of their first annual meeting after January 15, 2014, or October 31, 2014, to comply with new independence requirements for compensation committee members. Exemptions from the compensation committee independence requirements would apply to smaller reporting companies, controlled companies, limited partnerships, companies in bankruptcy, open-end management investment companies and foreign private issuers that disclose in their annual reports filed with the SEC the reasons why they do not have independent compensation committees.

Nasdaq Proposed Rules on Independence of Compensation Committee Members

Nasdaq's rules regarding oversight of executive officer compensation are set forth in Listing Rule 5605(d). Nasdaq proposes to make sweeping changes to current Listing Rule 5605(d). In general, the proposed changes are as follows:

- Listed companies must have a compensation committee of at least two members, each of whom must be an independent director as defined under Nasdaq's listing rules. Although listed companies may continue to rely on Nasdaq's existing exception that allows certain non-independent directors to serve on a compensation committee, such exception will only be available under exceptional and limited circumstances.
- Compensation committee members must not directly or indirectly accept any consulting, advisory or other compensatory fee, other than for board service, from the listed company or any of its subsidiaries.
- In determining whether a director is eligible to serve on a compensation committee, the board must consider whether the director is affiliated with the listed company, its subsidiaries 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.
- Listed companies must adopt a formal, written compensation committee charter that must specify the compensation committee responsibilities and authority in SEC Rule 10C-1 relating to the (i) authority to retain compensation consultants, legal counsel and other compensation advisers; (ii) authority to fund such advisers; and (iii) responsibility to consider certain independence factors before selecting such advisers, other than in-house legal counsel.
- Listed companies must review and reassess the adequacy of the compensation committee charter on an annual basis.
- Listed companies that are smaller reporting companies must have a compensation committee comprised of at least two independent directors and a formal written compensation committee charter or board resolution that specifies the compensation committee's responsibilities and authority, but the smaller reporting companies are not required to adhere to the compensation committee eligibility requirements relating to compensatory fees and affiliation or the requirements relating to compensation consultants, legal counsel and other compensation advisers that Nasdaq is proposing to adopt under SEC Rule 10C-1.

Under the proposed rules, listed companies must have a standing compensation committee and will no longer have the alternative of having a majority of independent directors vote on compensation for executive officers. Nasdaq considered whether such an alternative was still appropriate "given the heightened importance of compensation decisions in today's corporate governance environment." Nasdaq decided to eliminate the alternative because it "believes that there are benefits from a board having a standing committee dedicated solely to oversight of executive compensation. Specifically, directors on a standing compensation committee may develop expertise in a Company's executive compensation program in the same way that directors on a standing audit committee develop expertise in a Company's accounting and financial reporting processes. In addition, a formal committee structure may help promote accountability to stockholders for executive compensation decisions."

Under Nasdaq's current listing rules, a director may receive compensatory fees below certain thresholds from a listed company and still be considered independent. Audit committee members, however, are prohibited from receiving any compensatory fees from a listed company or its subsidiaries, with certain limited exceptions, in order to be considered independent. In its proposed rule filing, Nasdaq stated that "there is no compelling justification to have different

independence standards for audit and compensation committee members with respect to the acceptance of compensatory fees from a Company. Accordingly, Nasdaq proposes to adopt the same standard for compensation committee members that applies to audit committee members under Rule 10A-3 under the Exchange Act with respect to compensatory fees." Consistent with Rule 10A-3, compensatory fees do not include (i) fees received as a member of the compensation committee, the board of directors or any other board committee or (ii) fixed amounts of compensation under a retirement plan (including deferred compensation) for prior service with the listed company (provided that such compensation is not contingent in any way on continued service). The prohibition on compensatory fees does not include a "look-back" period and begins when the director begins service on the compensation committee.

With respect to effective dates, Nasdaq proposes that its rule relating to compensation committees having the specific compensation committee responsibilities and authority to comply with SEC Rule 10C-1 relating to the (i) authority to retain compensation consultants, legal counsel and other compensation advisers; (ii) authority to fund such advisers; and (iii) responsibility to consider certain independence factors before selecting such advisers, other than in-house legal counsel, be effective immediately. With respect to all other proposed rules, listed companies would have to comply with them by the earlier of (1) their second annual meeting held after the date of approval of Nasdaq's amended listing rules or (2) December 31, 2014. A listed company must certify to Nasdaq, no later than 30 days after the implementation deadline applicable to it, that it has complied with the amended listing rules on compensation committees (a form will be provided by Nasdaq for this certification).

NYSE and Nasdaq Independence Factors for Compensation Advisers

Both the NYSE and Nasdaq are amending their rules to provide that compensation committees consider the factors set forth in SEC Rule 10C-1 to determine the independence of compensation consultants, legal counsel or other advisers retained by compensation committees. These factors are as follows:

- The provision of other services to the listed company by the person that employs the compensation consultant, legal counsel or other adviser.
- The amount of fees received from the listed company by the person that employs the compensation consultant, legal counsel or other adviser, as a percentage of the total revenue of the person that employs the compensation consultant, legal counsel or other adviser.
- The policies and procedures of the person that employs the compensation consultant, legal counsel or other adviser that are designed to prevent conflicts of interest.
- Any business or personal relationship of the compensation consultant, legal counsel or other adviser with a member of the compensation committee.
- Any stock of the listed company owned by the compensation consultant, legal counsel or other adviser.
- Any business or personal relationship of the compensation consultant, legal counsel, other adviser or the person employing the adviser with an executive officer of the listed company.

The NYSE's and Nasdaq's respective proposed rules would not include any additional specific factors because both exchanges believe the list of factors included in SEC Rule 10C-1(b)(4) is comprehensive and provides compensation committees with the tools to consider the independence of compensation advisers.

Consistent with SEC Rule 10C-1, the proposed rules do not require compensation committees to retain independent compensation advisers. Instead, compensation committees are only required to conduct an independence analysis of compensation advisors. Compensation committees may still receive advice from non-independent counsel, such as internal counsel or outside counsel retained by management, or from non-independent compensation consultants or other advisers, including those engaged by management.

[1] The five "bright line" tests are as follows:

(i) The director is, or has been within the last three years, an employee of the listed company, or an immediate family member is, or has been within the last three years, an executive officer of the listed company.

(ii) The director or an immediate family member has received, during any 12-month period within the last three years, more than $120,000 in direct compensation from the listed company, other than director and committee fees and pension or other forms of deferred compensation for prior service (provided this compensation is not contingent in any way on continued service).

(iii) The director (a) is a current partner or employee of a firm that is the listed company's internal or external auditor; (b) has an immediate family member who is either a current partner of such a firm or an employee of such a firm who personally worked on the listed company's audit; or (c) was, or has an immediate family member who was, a partner or employee of such a firm and personally worked on the listed company's audit within the last three years.

(iv) The director or an immediate family member has been employed within the past three years as an executive officer of another company where any of the listed company's present executive officers at the same time served on that company's compensation committee.

(v) The director is a current employee, or an immediate family member is a current executive officer, of a company that has made payments to, or received payments from, the listed company for property or services in an amount which, in any of the last three fiscal years, exceeds the greater of $1 million or 2 percent of the other company's consolidated gross revenues.

[2] The NYSE stated that it "does not believe that it is appropriate to consider board compensation as part of the compensation committee independence determination with respect to individual directors. Non-executive directors devote considerable time to the affairs of the companies on whose boards they sit and eligible candidates would be difficult to find if board and committee service were unpaid in nature." Because all non-executive directors receive compensation for their services on the board, the NYSE "does not believe that an analysis of the board compensation of individual directors is a meaningful consideration in determining their independence for purposes of compensation committee service."