Securities Alert: NYSE, NASDAQ Propose Rules Regarding Compensation Committee and Adviser Independence

Related Attorneys

Aaron S. Berke

Adam K. Brandt

Elizabeth Turrell Farrar

Roger E. Lautzenhiser, Jr.

J. Bret Treier

Related Services

Corporate and Business Organizations

Corporate Governance

Employee Benefits and Executive Compensation

Securities Law Compliance

CLIENT ALERT | 10.1.2012

On September 25 and 26, 2012, respectively, New York Stock Exchange LLC (NYSE) and The NASDAQ Stock Market LLC (NASDAQ) proposed amendments to their listing standards to comply with the requirements of Section 10C of the Securities Exchange Act of 1934 (the Exchange Act), as set forth in Exchange Act Rule 10C-1, relating to the independence of compensation committees and compensation advisers.

Background

Exchange Act Rule 10C-1 requires that the national securities exchanges and associations adopt listing standards requiring that:

- Members of the compensation committee (or, in the absence of a committee, those directors who oversee executive compensation on behalf of the board of directors) be "independent"; and
- The compensation committee have access to compensation consultants, legal counsel and other advisers who are "independent."

These requirements are summarized below.

Independence of the Compensation Committee

Exchange Rule 10C-1(b)(1) requires that each member of the compensation committee (or, in the absence of a committee, those directors who oversee executive compensation on behalf of the board) be independent. The determination of "independence" must, at a minimum, consider:

- The director's sources of compensation, including any consulting, advisory or other compensatory fee paid by the issuer; and
- Whether the director is affiliated with the issuer, a subsidiary of the issuer, or any affiliate of a subsidiary of the issuer.

Access to and Independence of Compensation Advisers

Exchange Act Rules 10C-1(b)(2), (3) and (4) require that the compensation committee have access to compensation advisers who are independent. For this purpose, the compensation committee must:

- In its sole discretion, have the ability to retain or obtain the advice of a compensation consultant, independent legal counsel or other compensation adviser (collectively, compensation advisers);
- Be directly responsible for the appointment, compensation and oversight of the work of any compensation adviser retained by the compensation committee;
- Be provided with appropriate funding by the issuer for payment of reasonable compensation to such compensation advisers; and
- Before selecting a compensation adviser, take into consideration all factors relevant to that person's independence from management, including the following:
  - Any other services provided to the issuer by the person that employs the compensation adviser;
  - The amount of fees received from the issuer by the person that employs the compensation adviser as a percentage of that person's total revenue;
  - The policies and procedures of the person that employs the compensation adviser that are designed to prevent conflicts of interest;
  - Any business or personal relationship of the compensation adviser with a member of the compensation committee;
  - Any stock of the issuer owned by the compensation adviser; and
  - Any business or personal relationship between the issuer's executive officers and the compensation adviser.

Rule 10C-1 does not require that an independence assessment be performed prior to obtaining advice from in-house legal counsel.

Amendments to NYSE Corporate Governance Standards

To comply with the requirements of Exchange Act Section 10C and Exchange Act Rule 10C-1, NYSE has proposed the following revisions to its Corporate Governance Standards:

- Adding new Section 303A.02(a)(ii) within the provisions addressing the independence of directors. The board of directors will now be required to affirmatively determine the independence of any member of the compensation committee by considering "all factors specifically relevant to determining whether a director has a relationship with the listed company [and its subsidiaries] which is material to that director's ability to be independent from management in connection with the duties of a compensation committee member." The factors that the board is required to consider at a minimum are the same factors set forth in Exchange Act Rule 10C-1(b)(1).
- Amending Section 303A.05 to directly incorporate the rules set forth in Exchange Act Rules 10C-1(b)(2) through (4) relating to the authority of the compensation committee to retain, oversee and be provided with funding to pay compensation advisers and the requirement that the compensation committee consider the independence of a compensation adviser before selecting such compensation advisor.

Amendments to NASDAQ Listing Rules

To comply with the requirements of Exchange Act Section 10C and Exchange Act Rule 10C-1, NASDAQ has proposed to revise its Listing Rule 5605(d) in its entirety as follows:

- To require that all issuers maintain a compensation committee, eliminating the exception that allows issuers to have compensatory decisions involving executive officers be approved by a vote in which only independent directors participate.

- To require that the compensation committee consist of at least two members[1], each of whom must:
  - Be an "independent director" (as determined under current NASDAQ Listing Rule 5605(a)(2), which is unchanged); and
  - Not accept, directly or indirectly, any consulting, advisory or other compensatory fee from the issuer or any subsidiary, other than fees received as a member of the board or a board committee, or fixed amounts under a retirement plan for prior service with the issuer (provided that the compensation is not contingent on continued service).[2]

In determining whether a director is eligible to serve on the compensation committee, issuers must also consider whether the director is affiliated with the issuer, a subsidiary of the issuer, or an affiliate of a subsidiary of the issuer to determine whether such affiliation would impair the director's judgment as a member of the compensation committee.

- To require that the compensation committee have the authority and responsibility described in Exchange Act Rules 10C-1(b)(2) through (4) relating to the authority to retain and fund compensation advisers and the responsibility to assess compensation adviser independence, and that this authority and responsibility be included in a formal written compensation committee charter.

Opportunity to Cure

As required by Exchange Act Rule 10C, both the NYSE and NASDAQ proposals provide flexibility to issuers in the event that a compensation committee member ceases to be independent for reasons outside the member's reasonable control. In each case, the individual may continue serving on the compensation committee until the earlier of the next annual shareholders' meeting or one year from the occurrence of the event that caused the member to be no longer independent (except that the NASDAQ rules shorten this period to 180 days if the next annual shareholders' meeting occurs within 180 days of such event).

Exemptions

In addition to the exemptions described in Exchange Act Rule 10C-1, both NYSE and NASDAQ propose to exempt smaller reporting companies from the enhanced compensation committee independence requirements and from having to assess the independence of compensation advisers. However, the NASDAQ rules do not relieve smaller reporting companies from the obligation to maintain a compensation committee or adopt a compensation committee charter.

Effective Dates

Following SEC approval, the proposed amendments to the NYSE Corporate Governance Standards become effective July 1, 2013; however, issuers will have until the earlier of their first annual meeting after January 15, 2014 or October 31, 2014 to comply with the new listing standards as they relate to the independence of compensation committee members.[3]

The proposed amendments to NASDAQ Listing Rule 5605(d), relating to the compensation committee's authority to retain and fund compensation advisers and the responsibility to assess compensation adviser independence, become effective immediately upon SEC approval of those amendments. However, issuers would then have until their second annual meeting after the date on which the proposed amendments are approved by the SEC (but in no event later than December 31, 2014) to comply with the provisions relating to compensation committee independence and the adoption of a formal written compensation committee charter.

In addition, a NASDAQ listed company will be required to certify to NASDAQ, no later than 30 days after the implementation deadline applicable to it, that such listed company has complied with the amended Listing Rules on compensation committees.

---

[1] NASDAQ proposes to let one director (who is not an executive officer or a family member of an executive officer) who does not satisfy the independence criteria in proposed Listing Rule 5605(d)(2)(A) continue serving on the compensation committee under exceptional and limited circumstances, provided that the compensation committee consists of at least two others members each of whom is independent.

[2] In adopting this prohibition, NASDAQ noted that it was intentionally intended to align the proposed standards applicable to the compensation committee with the existing standards applicable to the audit committee.

[3] On October 1, 2012, NYSE published an updated rule filing clarifying the effectiveness of the new listing standards. The original rule filing indicated that issuers would have until the earlier of their first annual meeting after January 15, 2014, or October 31, 2014, to comply with all listing standards.