

NYSE and NASDAQ Proposed Compensation Committee and Advisers Independence Rules

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New listing standards to require additional independence criteria for compensation committee members and assessment of independence of compensation advisers.

On September 26, 2012, the New York Stock Exchange (NYSE) and the NASDAQ Stock Market (NASDAQ) proposed amendments to their corporate governance listing standards relating to compensation committee and adviser independence requirements, as directed by the final rules adopted by the **Securities and Exchange Commission (SEC)**, which implements Section 952 of the **Dodd-Frank Wall Street Reform and Consumer Protection Act (the Dodd-Frank Act)**.^[1]

The NYSE and NASDAQ proposed rules are expected to be released by the SEC for public comment following an initial review period and are scheduled to be adopted by the SEC by June 27, 2013. Accordingly, these new rules may not be applicable in the 2013 proxy season for calendar year companies, but, as discussed in more detail below, certain of NASDAQ's proposed rules relating to compensation committee responsibility and authority would become effective immediately upon SEC approval.

Background

The Dodd-Frank Act added Section 10C to the **Securities Exchange Act of 1934**, as amended (the Exchange Act), which requires the SEC to adopt rules directing the securities exchanges to prohibit the listing of any equity security of an issuer that is not in compliance with Section 10C's compensation committee and compensation adviser requirements. On June 20, 2012, the SEC adopted Final Rules implementing Section 10C requirements. The following discusses in more detail the NYSE and NASDAQ proposed rules.

NYSE Proposed Rules

Compensation Committee Independence

The NYSE proposed rules do not provide any bright-line test for independence nor do they include specific additional factors for consideration, except those set forth in Section 10C-1. Under NYSE's proposed rules, the board must consider all factors "specifically relevant" to determining whether a director has a relationship with the company that is material to that director's ability to be independent from management, including the two specified factors enumerated in Section 10C-1:

- Any compensation received by the director from any person or entity (including any consulting, advisory, or other compensatory fee paid by the company to such director)
- The director's affiliate relationship with the company, its subsidiary, or an affiliate of a subsidiary of the company

The commentary to the proposed rules provides that when considering the sources of a director's compensation, the board should examine whether the receipt of such compensation would impair the director's ability to make independent judgments about the company's executive compensation. With respect to affiliate relationship, the board should consider whether the relationship places the director under the direct or indirect control of the company or its senior management or creates a direct relationship between the director and members of senior management, in each case of a nature that would impair his or her ability to make independent judgments about the company's executive compensation. The commentary also reiterates that share ownership by the director should not, absent other factors, create an affiliate relationship that bars service on the compensation committee.

The NYSE proposed rules would include a cure period, during which a compensation committee member may continue to serve until the earlier of the next annual meeting or one year from the noncompliance event if such member ceases to be independent for reasons outside of the director's reasonable control. This cure period is available only if the compensation committee continues to have a majority of independent directors.

Compensation Adviser Requirements

The NYSE proposed rules relating to compensation adviser requirements largely track the related provisions in Rule 10C-1, particularly those relating to the powers of compensation committees to retain and obtain the advice of compensation consultants, independent legal counsel, and other advisers (collectively, Compensation Advisers). These compensation committee powers are, in significant part, already required by existing rules. Accordingly, the proposed rules adopted Rule 10C's provisions verbatim, requiring the compensation committee to (a) have the sole power to retain or obtain the advice of Compensation Advisers and (b) be responsible for the appointment, compensation, and oversight of such Compensation Advisers. In addition, NYSE-listed companies must provide appropriate funding for payment of reasonable compensation to such Compensation Advisers retained by the compensation committee.

Similarly, NYSE's proposed rules do not deviate from the Final Rules with respect to the requirements to assess the independence of Compensation Advisers. The proposed rules incorporate by reference the six factors enumerated in Section 10C-1, which must be considered by the compensation committee in determining the independence of Compensation Advisers selected by the compensation committee:

- Whether the employer of the Compensation Adviser is providing any other services to the issuer
- The amount of fees received from the issuer by the employer of the Compensation Adviser as a percentage of such employer's total revenue
- Policies and procedures that have been adopted by the employer of the Compensation

Adviser 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
- Any business or personal relationship of the Compensation Adviser or employer of the Compensation Adviser with an executive officer of the issuer

Consistent with the Final Rules, the NYSE proposed rules specify that the compensation committee is not required to engage in the required independence analysis before consulting with in-house legal counsel.

Exemption on Applicability

The NYSE proposed rules would exempt specified categories of companies from all new requirements, including controlled companies, limited partnerships, companies in bankruptcy, and companies with only preferred stock. Foreign private issuers are also exempt from the new requirements if they follow home country practices, and these companies under existing NYSE rules must disclose in annual reports any significant ways in which their corporate governance practice differs from those followed by domestic NYSE companies. In a departure from the Final Rules, NYSE's proposed rules do not require a foreign private issuer to disclose the reason why it does not have a compensation committee that complies with the enhanced independence standards.

The NYSE proposed rules generally exempt smaller reporting companies from the compensation committee independence requirements. All other parts of the NYSE proposed rules apply to smaller reporting companies, except for the requirement to test the independence of Compensation Advisers.

Implementation Timeline

If approved by the SEC, NYSE's proposed rules relating to the independence of compensation committee members will not become effective until the earlier of (i) the first annual meeting after January 15, 2012, or (ii) October 31, 2014. The remaining rules will become effective on July 1, 2013. This approach reflects the concern that some companies may require additional time to identify a suitable replacement if an existing compensation committee member does not meet the new independence criteria.

NASDAQ Proposed Rules

Compensation Committee Structure and Charter Requirements

Under current NASDAQ rules, a listed company is not required to have a formal compensation committee, and executive compensation may be determined either by a compensation committee consisted solely of independent directors or by a vote of a majority of independent directors of the board. NASDAQ's proposed rules would eliminate this option and require listed companies to have a standing compensation committee consisting of at least two directors, each of whom must satisfy the new proposed independence standards.

The NASDAQ proposed rules would also require listed companies to certify that they have adopted a formal written compensation committee charter and that the compensation committee will conduct annual review and assessment of its charter. Furthermore, the charter must address certain matters, including the scope of the committee's responsibilities, how it carries out its responsibilities, the committee's responsibilities for determining executive compensation, and specific responsibilities relating to the retention and compensation of Compensation Advisers and the assessment of their independence.

Compensation Committee Independence

In the implementation of the first factor enumerated in Section 10C-1 relating to compensation committee independence, NASDAQ has taken a different approach from NYSE and proposes a mandatory prohibition against service on the compensation committee if the director receives compensatory fees. Accordingly, NASDAQ's proposed rules would prohibit a compensation committee member from accepting, directly or indirectly, any consulting, advisory, or other compensatory fee from the company or its subsidiaries (other than directors' fees). This requirement follows the same criteria set forth in Section 10-A of the Exchange Act for audit committee membership under the Sarbanes-Oxley Act of 2002, as amended.

In contrast, NASDAQ would not impose a bar based on the second factor enumerated in Section 10C-1 and instead would require the board to consider the affiliate status of the director and whether such affiliation would impair the director's judgment as a member of the compensation committee. The interpretative guidance further provides that stock ownership by itself, or possession of a controlling interest through equity ownership, would not preclude a finding of independence. The NASDAQ proposed rules also reiterate that it may be appropriate for a representative of a significant stockholder to serve on the compensation committee because their interests are aligned with other stockholders in setting executive compensation.

The NASDAQ proposed rules include a cure period, during which, if a member of the compensation committee ceases to be independent for reasons beyond the member's reasonable control, the company may cure the deficiency by the earlier of its next annual meeting or one year from the noncompliance event, provided that the cure period cannot exceed 180 days from such event. The proposed rules do not affect the existing "exceptional and limited circumstances" exemption for compensation committee independence, which continues to be available.

Compensation Adviser Requirements

Similar to NYSE's proposed rules, NASDAQ's proposed rules follow closely the Final Rules without significant change with respect to the compensation committee's authority for the appointment, compensation, and oversight of any work of Compensation Advisers. Like NYSE, NASDAQ also did not believe it was necessary to propose any additional factors for consideration in determining the independence of Compensation Advisers selected by the compensation committee and adopted without change the six enumerated factors set forth in Section 10C-1.

Exemption on Applicability

The NASDAQ proposed rules would exempt specified categories of companies from all new requirements, including controlled companies, limited partnerships, asset-backed companies, management investment companies, and cooperatives. Foreign private issuers are also exempt from these requirements if they follow home country practices and disclose in their annual reports each requirement that is not followed. However, unlike NYSE, NASDAQ would require a foreign private issuer to disclose the reasons why it does not have an independent compensation committee.

The NASDAQ proposed rules would exempt smaller reporting companies from the enhanced compensation committee independence requirements, as well as the requirements relating to Compensation Advisers. However, smaller reporting companies would be required to have a standing compensation committee consisting of at least two independent directors who must satisfy the existing standard of independence. Smaller reporting companies are also required to have a written compensation committee charter or board resolution that specify the committee's responsibilities and authority, except those responsibilities and authority relating to Compensation Advisers under the proposed rules.

Implementation Timeline

Upon approval by the SEC, NASDAQ proposes to immediately make effective those provisions relating to a compensation committee's authority and its responsibility to select, retain, and fund Compensation Advisers and to assess their independence. The remaining provisions, including those relating to compensation committee structure, charter, and independence, will become effective at the earlier of (i) the second annual meeting held after SEC approval of the proposed rules or (ii) December 31, 2014.

Practical Considerations

Review and assessment of compensation committee composition: Companies and boards should analyze the independence of each member of their compensation committee and determine how the new listing standards would impact such analysis. The board and the compensation committee should be informed and educated so they can be prepared to undertake the necessary steps to comply with the rules. Any NASDAQ-listed company that currently does not have a standing compensation committee should begin considering forming such a committee.

Review of and amendments to compensation committee charters and D&O questionnaires: Companies should begin to update their committee charters, directors and officers (D&O) questionnaires, and corporate governance guidelines to reflect the new rules. In particular, NASDAQ-listed companies will need to include several additional provisions in committee charters to comply with the new requirements. While the proposed listing standards are subject to SEC review and will not be finalized until June 2013, we believe that most provisions in these proposed rules are unlikely to change; therefore, companies may want to amend their charters now and fine tune later if necessary.

Analysis of Compensation Adviser independence and conflicts of interest: Companies and compensation committees should establish or update procedures for collecting the information necessary to conduct the required independence and conflicts of interest analysis relating to Compensation Advisers. This may include new screening questionnaires for Compensation Advisers, additional interview sessions, and committee meetings to discuss independence and potential conflicts of interest. In addition, the Final Rules require companies to disclose conflicts of interest of compensation consultants in annual proxy statements for an annual or special meeting of stockholders occurring on or after January 1, 2013. Accordingly, companies should ensure that their disclosure and control procedures are designed to comply, in a timely manner, with these new disclosure requirements.

[1]. For more information on the SEC's final rules (Final Rules), see our September 19, 2012, LawFlash, "SEC Adopts Payment Disclosure Rules for Resource Extraction Issuers," [here](#).