

Client Alert.

October 3, 2012

Stock Exchanges Submit Proposed Compensation Committee and Adviser Independence Rule Changes to SEC

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As discussed in our [previous Client Alert](#), on June 20, 2012, the U.S. Securities and Exchange Commission (the “SEC”) adopted rules to implement the provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the “Dodd-Frank Act”) that affect the composition of compensation committees, the use of compensation advisers by companies listed on national securities exchanges, and disclosure provided by companies regarding their use of compensation consultants.¹ Under these rules, the national securities exchanges were directed to provide the SEC with proposed rule changes related to compensation committee and adviser independence by September 25, 2012.

On September 25, 2012, the New York Stock Exchange (“NYSE”) and Nasdaq submitted their proposed rule changes to the SEC.² Subject to any changes made to the proposals following discussions with the SEC, the proposals will be submitted for public comment and are then scheduled to be adopted by June 27, 2013.

BACKGROUND

Section 952 of the Dodd-Frank Act added Section 10C to the Securities Exchange Act of 1934 (the “Exchange Act”). Section 10C requires the SEC to direct the national securities exchanges and associations to prohibit the listing of any company issuing equity securities, subject to limited exceptions, unless specific conditions are satisfied with respect to the authority of the compensation committee, the independence of the members of the compensation committee, and the consideration by the compensation committee of specific factors relating to the independence of compensation advisers (including consultants, legal counsel and other advisers).

The rules adopted by the SEC direct the national securities exchanges to develop their own listing standards to implement these requirements of the Dodd-Frank Act. This approach is analogous to the implementation of the corporate governance provisions of the Sarbanes-Oxley Act of 2002 (the “Sarbanes-Oxley Act”), which required the SEC to adopt rules that directed the national securities exchanges to adopt certain corporate governance listing standards. The approach of using the SEC to direct the establishment of exchange listing standards recognizes the fact that the SEC’s oversight of public companies is principally with respect to required disclosures, while the national securities exchanges can impose conditions on substantive practices of public companies as listing requirements.

COMPENSATION COMMITTEE MEMBER INDEPENDENCE

Under the SEC’s rules, the exchanges were directed to adopt listing standards related to the independence of compensation committee members. Although neither the Dodd-Frank Act nor the SEC’s rules specifically define

¹ [Listing Standards for Compensation Committees, Securities Act Release No. 33-9330, Exchange Act Release No. 34-67220 \(June 20, 2012\)](#).

² [New York Stock Exchange, Form 19b-4 Proposed Rule Change by New York Stock Exchange \(Sept. 25, 2012\), amended by New York Stock Exchange, Amendment No. 1 to Form 19b-4 Proposed Rule Change by New York Stock Exchange \(Oct. 1, 2012\); The NASDAQ Stock Market LLC, Form 19b-4 Proposed Rule Change by NASDAQ Stock Market \(Sept. 25, 2012\)](#).

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independence for this purpose, the rules adopted by national securities exchanges must consider:

- the sources of compensation of the director, including any consulting, advisory, or other compensatory fee paid by the company to the director; and
- whether the director is affiliated with the company or any of its subsidiaries or their affiliates.

These rules provided the exchanges with more discretion in setting the definition of independence than is permitted in determining the independence of audit committee members.³ The SEC also did not adopt any additional factors to be considered by the exchanges in establishing their listing standards beyond what was required under the Dodd-Frank Act, which left open the possibility that the exchanges would consider and adopt additional relevant factors to be considered when determining whether a compensation committee member is independent.

The changes proposed by the NYSE and Nasdaq do not, however, include additional criteria to be considered in determining whether a member of the compensation committee is independent. The commentary to both the NYSE's and Nasdaq's proposals makes clear that in order to be considered independent, members of the compensation committee must meet both the general independence criteria already included in the exchanges' listing standards and the new, compensation committee-specific criteria required by the SEC rules.

The NYSE proposal provides some guidance as to how issuers should apply the two factors listed above in making an independence determination. With respect to sources of compensation, the NYSE commentary instructs the listed company's board to consider whether the director receives compensation from any person or entity that would impair the director's ability to make independent judgments about the listed company's executive compensation. Similarly, when considering any affiliate relationship, the proposed commentary provides that the board should consider whether there is an affiliate relationship that places the director "under the direct or indirect control of the listed 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 ability to make independent judgments about the listed company's executive compensation." The NYSE proposal specifically declined to adopt a bar on independence based solely on affiliate status due to stock ownership.

Unlike the NYSE approach, Nasdaq's proposal attempts to harmonize the committee-specific independence standards applicable to members of audit and compensation committees by applying the independence standards currently required of audit committee members to directors serving on compensation committees. Accordingly, Nasdaq's proposal prohibits a compensation committee member from accepting directly or indirectly any consulting, advisory, or other compensatory fee from an issuer or any subsidiary. As is the case with Nasdaq's audit committee independence requirements, an individual's status as an affiliate due solely to stock ownership is not an automatic bar to an independence determination.⁴ Instead, in making this eligibility determination, the board must consider whether a director's status as an affiliate due to stock ownership "would impair the director's judgment as a member of the compensation committee." There is no "look-back" period for these requirements, which only begin with the member's term of service on the compensation committee.

³ Section 301 of the Sarbanes-Oxley Act specifies that in order to be considered independent, a member of the audit committee may not, other than in his or her capacity as a member of the audit committee, the board of directors, or any other committee: (i) accept any consulting, advisory, or other compensatory fee from the company; or (ii) be an affiliated person of the company or any subsidiary thereof.

⁴ Nasdaq noted in the commentary to its proposal that, unlike audit committees, "it may be appropriate for certain affiliates, such as representatives of significant stockholders, to serve on compensation committees since their interests are likely aligned with those of other stockholders in seeking an appropriate executive compensation program."

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Nasdaq's proposed changes go a step further than required under the Dodd-Frank Act or the related SEC rules in requiring all listed companies to have a standing compensation committee with at least two members. By contrast, Nasdaq's current listing standards require that compensation of the chief executive officer and other executive officers of a company must be determined, or recommended to the board for determination, either by: (i) a compensation committee comprised solely of independent directors; or (ii) independent directors constituting a majority of the board's independent directors in a vote in which only independent directors participate.

COMPENSATION COMMITTEE AUTHORITY AND FUNDING

The SEC rules also directed the exchanges to prohibit the listing of a security of an issuer that is not in compliance with the following standards:

- The compensation committee, which for this purpose includes those members of the board of directors who oversee executive compensation matters on behalf of the board of directors in the absence of a board committee, must be directly responsible for the appointment, compensation, and oversight of the work of any compensation advisers;
- The compensation committee, in its sole discretion, must have authority to retain or obtain the advice of compensation advisers;
- The issuer must provide the appropriate funding for the payment of reasonable compensation, as determined by the compensation committee, to the compensation advisers, if any; and
- Before selecting any compensation adviser, the compensation committee must take into consideration the six independence criteria specified in Rule 10C-1 (described below), as well as any additional factors specified in the listing criteria adopted by the exchanges.

The SEC made clear that these new rules do not require that the compensation committee act in accordance with the advice of compensation advisers or otherwise affect the ability or obligation of the compensation committee to exercise its own judgment. Further, the rules and the resulting listing standards are not intended to preclude the engagement of non-independent legal counsel, nor obtaining advice from in-house or outside counsel retained by the company, although in the case of the latter, the compensation committee will still be required to conduct an independence assessment.

The NYSE and Nasdaq proposals both would require companies to impose the requirements listed above on their compensation committees. The NYSE noted in its commentary that the required powers of the compensation committee set forth above had been in significant part already required by existing NYSE listing standards, which require these powers to be included in the compensation committee charter. In any case, the NYSE proposed to adopt the requirements noted above exactly as they appear in the SEC rules, and to remove the comparable requirements included in existing NYSE rules. Nasdaq's proposal also requires that, subject to certain exceptions described below, listed companies adopt a formal compensation committee charter that states that the compensation committee will review and reassess the adequacy of the charter on an annual basis.⁵ The rule changes proposed by the NYSE and Nasdaq require that the above-referenced authority and funding considerations be addressed in the compensation committee charter.

⁵ This requirement is a shift from Nasdaq's annual review requirement applicable to audit committee charters, which requires the charter to state that the audit committee *has* reviewed and reassessed the adequacy of the charter on an annual basis. See Nasdaq Listing Rule 5605(c)(1). Nasdaq's proposal would modify the audit committee requirement to make it prospective as well.

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COMPENSATION ADVISER INDEPENDENCE

The SEC rules also directed the exchanges to adopt listing standards requiring that the compensation committee consider the independence factors specified in the rules, as well as any other relevant factors identified by the exchange, prior to engaging any compensation advisers.⁶ The independence criteria specified in the SEC rules are:

- The provision of other services to the company by the firm employing the compensation adviser;
- The amount of fees received from the company by the firm employing the compensation adviser, as a percentage of that firm's total revenue;
- The policies and procedures adopted by the firm employing 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;
- The compensation adviser's ownership of the company's stock; and
- Any business or personal relationships between the company's executive officers and the compensation adviser or the firm employing the adviser.

As with the criteria relating to compensation committee member independence, the rule changes proposed by the NYSE and Nasdaq did not include any additional factors to be considered in determining the independence of compensation advisers beyond those in the SEC rules. In the NYSE's comments to its proposal, the NYSE noted that it "would not include any specific additional factors for consideration, as the Exchange believes that the list included in Rule 10C-1(b)(4) is very comprehensive and the proposed listing standard would also require the compensation committee to consider any other factors that would be relevant to the adviser's independence from management."

EXEMPTIONS AND APPLICABILITY OF LISTING STANDARDS

The proposed listing standards for compensation committee member independence and compensation committee adviser independence would not apply to controlled companies, issuers of securities futures products cleared by a registered clearing agency or a clearing agency exempt from registration, or registered clearing agencies that issue standardized options. The following categories of companies would also be exempt from the compensation committee member independence requirement:

- limited partnerships;
- companies in bankruptcy proceedings;
- open-end management investment companies registered under the Investment Company Act of 1940;
- foreign private issuers that disclose annually why they do not have an independent compensation committee; and
- smaller reporting companies.

⁶ The SEC rules and the exchanges' proposed rule changes make clear that, although the six factors must be considered prior to engaging a compensation adviser, a compensation committee need not consider the six independence factors before consulting with or obtaining advice from in-house counsel.

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Both the NYSE and Nasdaq proposed general exemptions for other categories of issuers that are currently exempt from their existing compensation committee requirements. These include passive business organizations and issuers whose only listed equity security is a preferred stock.

The rules of both the NYSE and Nasdaq currently provide that a foreign private issuer may follow its home country's practice rather than U.S. compensation-related listing rules so long as the issuer discloses in its annual reports filed with the SEC each requirement that it does not follow and describes the home country practice followed by the issuer in lieu of such requirements. Under both the NYSE and Nasdaq proposals, a foreign private issuer that follows its home country's practice in lieu of the requirement to maintain an independent compensation committee must now also disclose in its annual reports filed with the SEC the reasons why it does not have such a committee.

While the NYSE proposal would, in general, exempt smaller reporting companies from the compensation committee independence requirements, Nasdaq's proposal would generally require smaller reporting companies to comply with the member independence requirements. Nasdaq's proposal also would permit smaller reporting companies to adopt a board resolution that specifies the compensation committee's responsibilities and authority in lieu of adopting a formal written compensation committee charter. Further, under Nasdaq's proposal, smaller reporting companies would not be required to adhere to the new requirements relating to compensatory fees and affiliation, nor to include language regarding the committee's authority to retrain compensation advisers in the compensation committee charter or board resolutions. Under Nasdaq's proposal, smaller reporting companies would also be exempt from the requirement to review the compensation committee charter or board resolutions on an annual basis.

IMPLEMENTATION TIMELINE

The proposed rule changes must be approved by the SEC and adopted by the exchanges by June 27, 2013.

Under the NYSE proposal, companies would have until the earlier of (1) their first annual meeting after January 15, 2014, or (2) October 31, 2014, to comply with the new compensation committee independence requirements. Companies would be required to comply with the other proposed changes, including those related to compensation committee advisers, by July 1, 2013. Under the Nasdaq proposal, companies would have until the earlier of (1) their second annual meeting held after the date of the SEC's approval of Nasdaq's proposal, or (2) December 31, 2014, to comply with the proposed rules. Nasdaq's new rules related to the funding and authority of the compensation committee would be effective immediately.

The rules proposed by both the NYSE and Nasdaq would provide listed companies with opportunities to cure compensation committee member independence issues after the new standards go into effect. Under the NYSE proposal, if a member of a compensation committee ceases to be independent for reasons outside the member's reasonable control, that member may remain on the compensation committee until the earlier of the next annual meeting or one year from the occurrence of the event that caused the member to be no longer independent. Notably, however, the cure period provided under the NYSE proposal is limited to circumstances where the compensation committee continues to have a majority of directors who are independent under the proposed rules. Under the Nasdaq proposal, the listed company would be required to cure any noncompliance by the earlier of the next annual shareholders meeting or one year from the occurrence of the event that caused the noncompliance.⁷ Both exchanges' proposals would require companies to notify

⁷ Nasdaq's proposal provides that if the annual shareholders meeting occurs within less than 180 days following the event that caused the noncompliance, the company "shall instead have 180 days from such event to regain compliance." As Nasdaq notes in its proposal, this provides the company at least 180 days to cure noncompliance and would allow most companies to regain compliance in connection with their next annual meetings.

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the relevant exchange upon learning of noncompliance.

Both the NYSE and Nasdaq proposals generally would provide a phased-in compliance period for newly listed companies. These issuers would be required to have one independent compensation committee member at the time of listing, a majority of independent compensation committee members within 90 days of listing, and all independent compensation committee members within one year of listing.

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