

## **NYSE and Nasdaq Propose Changes to Listing Standards Regarding Compensation Committees and Compensation Advisers**

The New York Stock Exchange LLC (“NYSE”) and The NASDAQ Stock Market LLC (“Nasdaq”) have filed with the Securities and Exchange Commission (“SEC”) proposed rule changes to their existing listing standards regarding compensation committees and compensation advisers (the “Proposed Rule Changes”).<sup>1</sup> The Proposed Rule Changes are required in order to comply with Section 952 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank Act”) and Rule 10C-1 of the Securities Exchange Act of 1934 (“Exchange Act”).<sup>2</sup> The SEC has 45 days (or 90 days, if the SEC so designates) from the date that notice regarding the Proposed Rule Changes is published in the Federal Register to approve or disapprove the Proposed Rule Changes by order or to institute proceedings to determine whether the Proposed Rule Changes should be disapproved. As part of its deliberative process, the SEC has invited interested persons to comment on the Proposed Rule Changes.

Since most public companies currently have compensation committees comprised solely of independent directors, the Proposed Rule Changes are not expected to effect any fundamental changes. Companies should review their existing compensation committee charters to ensure that the provisions relating to compensation advisers will comply with the Proposed Rule Changes. Companies listed on Nasdaq will also need to have a written charter and a minimum of two members.

### **I. The NYSE’s Proposed Rule Changes**

The NYSE’s Proposed Rule Changes are primarily limited to implementing Exchange Act Rule 10C-1 (“Rule 10C-1”) and generally provide as follows:

- In affirmatively determining the independence of any director who will serve on the compensation committee of a listed company’s board of directors (“Board”), the Board is required to consider all factors specifically relevant to determining whether that director has a relationship to the company which is material to the director’s ability to be independent from management in connection with the duties of a compensation committee member, including, but not limited to (i) the source of the director’s compensation, including any consulting, advisory or other compensatory fees paid by the listed company and (ii) whether the director has an affiliate relationship with the company, a subsidiary or an affiliate of a subsidiary.<sup>3</sup>

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<sup>1</sup> The NYSE’s Proposed Rule Changes were originally filed with the SEC on September 25, 2012, but were then amended and replaced in their entirety on October 1, 2012. The revised version is *available at* [http://www.nyse.com/nysenotices/nyse/rule-filings/pdf?file\\_no=SR-NYSE-2012-49&seqnum=2](http://www.nyse.com/nysenotices/nyse/rule-filings/pdf?file_no=SR-NYSE-2012-49&seqnum=2). Nasdaq’s Proposed Rule Changes were filed with the SEC on September 26, 2012, and are *available at* <http://nasdaq.cchwallstreet.com/NASDAQ/pdf/nasdaq-filings/2012/SR-NASDAQ-2012-109.pdf>.

<sup>2</sup> The Dodd-Frank Act is *available at* <http://www.govtrack.us/congress/billtext.xpd?bill=h111-4173>. Section 952 of the Dodd-Frank Act added Section 10C to the Exchange Act. The SEC adopted Exchange Act Rule 10C-1 on June 20, 2012, and the rule became effective on July 27, 2012. For further discussion of Exchange Act Rule 10C-1, *see* our firm memorandum, *SEC Adopts Final Rules Regarding Compensation Committees and Compensation Advisers* (June 27, 2012), *available at* [http://www.cahill.com/news/memoranda/1012960/res/id=sa\\_File1/CGR%20Memo%20-%20SEC%20Adopts%20Final%20Rules%20Regarding%20Compensation%20Committees%20and%20Compensation%20Advisers.pdf](http://www.cahill.com/news/memoranda/1012960/res/id=sa_File1/CGR%20Memo%20-%20SEC%20Adopts%20Final%20Rules%20Regarding%20Compensation%20Committees%20and%20Compensation%20Advisers.pdf).

<sup>3</sup> The NYSE declined to adopt any specific numerical tests with respect to these factors or to adopt a requirement to consider any other particular factors. In particular, the NYSE declined to adopt an absolute prohibition on a Board making an affirmative finding that a director is independent if the director or any of the director’s affiliates owned more than some

- Compensation committees of listed companies may, in their sole discretion, retain or obtain the advice of compensation consultants, independent legal counsel or other advisers (collectively, “compensation advisers”), and the compensation committees are directly responsible for the appointment, compensation and oversight of the work of any compensation advisers. The Proposed Rule Changes would also require that listed companies provide for appropriate funding, as determined by the compensation committee, for payment of reasonable compensation to a compensation adviser that the compensation committee retains.<sup>4</sup>
- Compensation committees of listed companies may select a compensation adviser only after taking into consideration all factors relevant to that person’s independence from management, including the following specific factors (“Independence Factors”):<sup>5</sup>
  - (i) The provision of other services to the listed company by the person that employs the compensation adviser;
  - (ii) The amount of fees received from the listed company by the person that employs the compensation adviser, as a percentage of such person’s total revenue;
  - (iii) The policies and procedures of the person that employs the compensation adviser that are designed to prevent conflicts of interest;
  - (iv) Any business or personal relationship of the compensation adviser with a member of the compensation committee;
  - (v) Any stock of the listed company owned by the compensation adviser; and
  - (vi) Any business or personal relationship of the compensation adviser or the person employing the adviser with an executive officer of the listed company.<sup>6</sup>
- If a member of the compensation committee ceases to be independent for reasons outside the member’s reasonable control, that person, with notice by the listed company to the NYSE, may remain a compensation committee member until the earlier of the next annual meeting or one year from the occurrence of the event that caused the member to no longer be independent, so long as the committee continues to have a majority of independent directors.

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specified percentage of the shares of the listed company.

<sup>4</sup> The NYSE also proposes to modify its commentary to these Proposed Rule Changes to include a provision stating that the compensation committee charter must provide that the committee has all of these specific powers.

<sup>5</sup> These are the same six independence factors identified by the SEC in Rule 10C-1.

<sup>6</sup> The Proposed Rule Changes would include an explicit statement that, consistent with Rule 10C-1, nothing in the Proposed Rule Changes should be construed (i) to require the compensation committee to implement or act consistently with the advice or recommendations of the compensation adviser; or (ii) to affect the ability or obligation of the compensation committee to exercise its own judgment in fulfilling its duties. The Proposed Rule Changes would also specify that the compensation committee need not engage in an analysis of the Independence Factors before consulting with or obtaining advice from in-house legal counsel.

- Each category of issuer that qualifies for a general or specific exemption under Rule 10C-1 or the NYSE's existing compensation committee requirements would be exempt from the Proposed Rule Changes. Thus, (i) controlled companies, (ii) smaller reporting companies, (iii) limited partnerships, (iv) companies in bankruptcy, (v) open-end management investment companies registered under the Investment Company Act of 1940, (vi) passive business organizations in the form of trusts, (vii) derivatives and special purpose securities, (viii) issuers whose only listed equity security is a preferred stock and (ix) foreign private issuers that follow home country practice in lieu of having an independent compensation committee would be exempt from the Proposed Rule Changes.<sup>7</sup>
- If approved by the SEC, listed companies would have until the earlier of (i) their first annual meeting after January 15, 2014 or (ii) October 31, 2014 to comply with the new compensation committee director independence standards; the other Proposed Rule Changes would become operative on July 1, 2013.

## II. Nasdaq's Proposed Rule Changes

Nasdaq's Proposed Rule Changes not only implement Rule 10C-1, but also include several additional requirements that more closely align the Nasdaq listing standards with existing NYSE rules. Nasdaq's Proposed Rule Changes generally provide as follows:

- Listed companies must have a standing compensation committee consisting of at least two members, each of whom must be an "independent director," as defined under Nasdaq's current listing rules ("Independent Director").<sup>8</sup>
- In order to preserve their independence, compensation committee members would not be permitted to accept, directly or indirectly, any consulting, advisory or other compensatory fee, other than for Board service, from a listed company or any subsidiary.<sup>9</sup> There would be no "look-back" period, so the prohibition on the receipt of any consulting, advisory or other compensatory fee by a compensation committee member would begin with the member's term of service on the compensation committee.

<sup>7</sup> "Controlled company" refers to a listed company in which more than 50% of the voting power for the election of directors is held by an individual, a group or another company; "smaller reporting company" refers to a company with a public float of less than \$75 million; "limited partnership" refers to a form of business ownership and association consisting of one or more general partners who are fully liable for the debts and obligations of the partnership and one or more limited partners whose liability is limited to the amount invested; "open-end management investment company" refers to an investment company, other than a unit investment trust or face-amount certificate company, that offers for sale or has outstanding any redeemable security of which it is the issuer; "foreign private issuer" refers to any foreign issuer other than a foreign government, except for an issuer that has more than 50% of its outstanding voting securities held of record by U.S. residents and any of the following: a majority of its officers and directors are citizens or residents of the U.S., more than 50% of its assets are located in the U.S. or its business is principally administered in the U.S.

<sup>8</sup> See Nasdaq Listing Rule 5605(a)(2). Nasdaq's current listing rules do not impose size requirements on any Board committees, other than audit committees, and require that compensation of a company's executive officers 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. Although Nasdaq was not required to implement a requirement for a standing compensation committee or a minimum size requirement for such a committee pursuant to Rule 10C-1, Nasdaq explained in the filing that it decided to do so in light of the heightened importance of compensation decisions to stockholders in today's corporate governance environment.

<sup>9</sup> This would be the same standard that applies to audit committee members under Exchange Act Rule 10A-3.

- In determining whether a director is eligible to serve on a compensation committee, a listed company's Board would be required to consider whether the director is affiliated with the company, a subsidiary or an affiliate of a subsidiary in order to determine whether such affiliation would impair the director's judgment as a member of the compensation committee.<sup>10</sup> In performing this analysis, a Board would not be required to apply a "look-back" period, and would therefore be required to consider affiliation only with respect to relationships that occur during an individual's term of service as a compensation committee member.
- Listed companies may continue to rely on Nasdaq's existing exception that allows certain non-Independent Directors to serve on a compensation committee under exceptional and limited circumstances.<sup>11</sup>
- Under certain circumstances, a listed company that fails to comply with the compensation committee composition requirements of the Proposed Rule Changes may take advantage of a cure right. Specifically, if a company fails to comply with the compensation committee composition requirements due to one vacancy, or one compensation committee member ceases to be independent due to circumstances beyond the member's reasonable control, the company may regain compliance by the earlier of the next annual shareholders' meeting or one year from the occurrence of the event that caused the noncompliance. If the annual shareholders' meeting occurs no later than 180 days following the event that caused the noncompliance, however, the company would instead have 180 days from that event to regain compliance. A company relying on this provision would be required to provide notice to Nasdaq immediately upon learning of the event or circumstance that caused the noncompliance.<sup>12</sup>
- Listed companies would be required to certify that they have adopted a formal written compensation committee charter and that the compensation committee will review and reassess the adequacy of such charter on an annual basis.<sup>13</sup> The Proposed Rule Changes would require the compensation committee charter to specify:

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<sup>10</sup> Although the Proposed Rule Changes would require a Board to consider affiliation in making an eligibility determination for compensation committee members, the Proposed Rule Changes would not prohibit a Board from permitting a director who is an affiliate to serve on the compensation committee.

<sup>11</sup> Under this exception, if a compensation committee consists of at least three members, one director who is not an Independent Director and is not currently an executive officer, employee or a family member of an executive officer, may be appointed to the compensation committee if the Board, under exceptional and limited circumstances, determines that such individual's membership on the committee is required by the best interests of the company and its shareholders. A company that relies on this exception must disclose either on or through the company's website or in the proxy statement for the next annual meeting subsequent to such determination (or, if the company does not file a proxy, in its Form 10-K or 20-F), the nature of the relationship and the reasons for the determination. In addition, the company must provide any disclosure required by Instruction 1 to Item 407(a) of Regulation S-K regarding its reliance on this exception. A member appointed under this exception may not serve longer than two years.

<sup>12</sup> This proposed cure period is the same as the cure period in Nasdaq's current listing rules for noncompliance with the requirement to have a majority independent Board.

<sup>13</sup> This Proposed Rule Change is similar to Nasdaq's current requirement for companies to certify as to the adoption of a formal written audit committee charter, except that the proposed requirement for annual review and reassessment of the adequacy of the compensation committee charter is written prospectively, rather than retrospectively (*i.e.*, the proposed compensation committee charter requirement states that the compensation committee *will review and reassess* the adequacy of the charter on an annual basis, while the current audit committee charter requirement states that the audit committee *has reviewed and reassessed* the adequacy of the charter on an annual basis).

- The scope of the compensation committee’s responsibilities and how it carries out those responsibilities, including structure, processes and membership requirements;
  - The compensation committee’s responsibility for determining, or recommending to the Board for determination, the compensation of the company’s executive officers;
  - That the chief executive officer of the company may not be present during voting or deliberations by the compensation committee on his or her compensation;<sup>14</sup> and
  - The specific compensation committee responsibilities and authority relating to the: (i) authority to retain compensation advisers; (ii) authority to fund such advisers; and (iii) responsibility to consider the Independence Factors before selecting such advisers, other than in-house legal counsel.
- Before selecting a compensation adviser (other than in-house legal counsel), a compensation committee would be required to consider the Independence Factors with respect to the compensation adviser.<sup>15</sup>
  - Nasdaq’s existing exemptions from the compensation-related listing rules would remain generally unchanged with respect to the Proposed Rule Changes. Thus, asset-backed issuers and other passive issuers, cooperatives, limited partnerships, management investment companies and controlled companies, which are exempt from Nasdaq’s existing compensation-related listing rules, would also be exempt from the Proposed Rule Changes. In addition, a foreign private issuer would continue to be allowed to follow its home country practice in lieu of the Proposed Rule Changes relating to compensation committees, so long as the foreign private issuer discloses this in its annual reports filed with the SEC and describes the home country practice it follows instead. The Proposed Rule Changes would also require any foreign private issuer that follows its home country practice in lieu of the requirement to have an independent compensation committee to disclose in its annual reports filed with the SEC the reasons why it does not have such a committee.
  - Smaller reporting companies would be required to have a compensation committee comprised of at least two Independent Directors and a formal written compensation committee charter or Board resolution that specifies the committee’s responsibilities and authority,<sup>16</sup> but such companies would not be required to adhere to the compensation committee eligibility requirements relating to compensatory fees and affiliation or the requirements relating to compensation advisers that are contained in the Proposed Rule Changes.

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<sup>14</sup> This requirement is based upon Nasdaq’s current compensation-related listing rules. *See* Nasdaq Listing Rule 5605(d)(1).

<sup>15</sup> Consistent with Rule 10C-1, although a compensation committee would be required to consider the Independence Factors before selecting a compensation adviser (other than in-house legal counsel), the compensation committee would not be required to retain a compensation adviser who is independent or to retain any compensation adviser at all.

<sup>16</sup> Unlike other companies, smaller reporting companies may include this content in a Board resolution, rather than a compensation committee charter. In addition, smaller reporting companies would not be required to review and reassess the adequacy of the charter or Board resolution on an annual basis. And, although the charter or Board resolution would be required to specify the same content as those of other companies, smaller reporting companies would not be required to specify the particular compensation responsibilities and authority relating to the: (i) authority to retain compensation advisers; (ii) authority to fund such advisers; and (iii) responsibility to consider the Independence Factors before selecting such advisers.



- Nasdaq will provide a phase-in schedule consistent with its existing phase-in schedules relating to compensation committee composition for: (i) companies listing in connection with an initial public offering; (ii) companies emerging from bankruptcy; and (iii) companies ceasing to be controlled companies. Since these categories of companies are not required to have a compensation committee prior to listing, each would be allowed to phase in compliance with the compensation committee composition requirement as follows: (1) one independent member at the time of listing; (2) a majority of independent members within 90 days of listing; and (3) all independent members within one year of listing. These phase-in schedules would remain unchanged under the Proposed Rule Changes, except that the Proposed Rule Changes would clarify that a company may phase in compliance with the minimum size requirement, the requirement that compensation committee members be Independent Directors and the additional eligibility requirements for compensation committee membership required by the Proposed Rule Changes.

In addition, no changes would be made to the phase-in schedule for companies transferring from other markets. Companies transferring from other markets with a substantially similar requirement would be afforded the balance of any grace period afforded by the other market. Companies transferring from other listed markets that do not have a substantially similar requirement would be afforded one year from the date of listing on Nasdaq to comply with the compensation committee composition requirements.<sup>17</sup>

Pursuant to the Proposed Rule Changes, a company ceasing to be a smaller reporting company would be required to comply with the same schedule as a company listing in conjunction with an initial public offering. Since a smaller reporting company is required to have a compensation committee comprised of at least two Independent Directors, a company that has ceased to be a smaller reporting company may use the phase-in schedule for the additional eligibility requirements relating to compensatory fees and affiliation, but not for the minimum size requirement or the requirement that the committee consist only of Independent Directors. This phase-in schedule would start to run on the due date of the SEC filing in which the company is required to report that it is an issuer other than a smaller reporting company. During the phase-in schedule, a smaller reporting company would be required to continue complying with the requirement to have a compensation committee comprised of at least two Independent Directors.

- If approved by the SEC, the Proposed Rule Changes which require that a compensation committee have the specific responsibilities and authority necessary to comply with Rule 10C-1 relating to the: (i) authority to retain compensation advisers; (ii) authority to fund such advisers; and (iii) responsibility to consider the Independence Factors before selecting such advisers would become effective immediately. To the extent that a company does not have a compensation committee, the provisions of these particular Proposed Rule Changes would apply to the Independent Directors who determine, or recommend to the Board for determination, the compensation of the chief executive officer and all other executive officers of the company.<sup>18</sup>

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<sup>17</sup> None of the phase-in schedules apply to the requirement to adopt a formal written compensation committee charter containing the content specified in the Proposed Rule Changes.

<sup>18</sup> In the filing, Nasdaq advises companies to consider their state corporate law in determining whether to initially grant these specific responsibilities and authority through a charter, resolution or other Board action. While Nasdaq proposes that companies must eventually have a written compensation committee charter that includes these responsibilities and authority, companies may implement such a charter on the same schedule as the other Proposed Rule Changes.

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Listed companies would be required to comply with the remaining provisions of the Proposed Rule Changes by the earlier of: (i) their second annual meeting held after the date of approval of the Proposed Rule Changes; or (ii) December 31, 2014.

A company must certify to Nasdaq, no later than 30 days after the implementation deadline applicable to it, that it has complied with the Proposed Rule Changes regarding compensation committees. Nasdaq will provide companies with the relevant form for this certification.

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If you have any questions about the issues addressed in this memorandum or if you would like a copy of any of the materials mentioned, please do not hesitate to call or email Charles A. Gilman at 212.701.3403 or [cgilman@cahill.com](mailto:cgilman@cahill.com); Jon Mark at 212.701.3100 or [jmark@cahill.com](mailto:jmark@cahill.com); John Schuster at 212.701.3323 or [jschuster@cahill.com](mailto:jschuster@cahill.com); Glenn Waldrip at 212.701.3110 or [gwaldrip@cahill.com](mailto:gwaldrip@cahill.com); or Abigail Darwin at 212.701.3240 or [adarwin@cahill.com](mailto:adarwin@cahill.com).

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