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# NYSE and NASDAQ Issue Proposed Rules on Compensation Committee Independence Standards

As required pursuant to the Dodd-Frank Wall Street Reform and Consumer Protection Act and the final rule issued by the U.S. Securities and Exchange Commission (the "SEC") in June 2012, the New York Stock Exchange (the "NYSE") and NASDAQ each issued proposed rules on the independence of compensation committees and their advisers on September 25, 2012. The proposed rules are subject to approval by the SEC.

## NYSE Proposed Rules

NYSE issued proposed changes to Sections 303A.00, 303A.02(a) and 303A.05 of its Listed Company Manual that would require a company's board of directors to: (i) consider additional factors in assessing the independence of its compensation committee members and (ii) evaluate the independence of compensation committee advisers using the SEC's requirements set forth in Rule 10C-1(b)(4) of the Securities Exchange Act of 1934, as amended (the "Exchange Act").

### Compensation Committee Independence

In addition to the NYSE's general director independence standards set forth in Section 303A.02 of the Listed Company Manual, the proposed rules would require members of a company's compensation committee to meet further independence requirements. To determine the independence of a director who would serve on the compensation committee, the board would have to consider "whether a director has a relationship to the listed company which is material to that director's ability to be independent from management in connection with the duties of a compensation committee member." This consideration would include, among other factors:

- The source of the director's compensation received from the company or otherwise and whether such compensation "would impair his ability to make independent judgments;" and
- Any affiliate relationships between the director and the company, any subsidiaries of the company and any affiliates of a subsidiary, specifically whether the affiliate relationship creates a direct relationship between the director and the company's senior management or places the director under the direct or indirect control of the company or its senior management such that the director's ability to make independent judgments about the company's executive compensation would be impaired.

NYSE declined to adopt any specific numerical tests with regard to these proposed factors. Further, NYSE affirmatively supported the SEC's commentary in its final ruling that "not all affiliate relationships would adversely affect a director's ability to be independent from management," in particular when a director owns shares in the company.

### Compensation Adviser Independence

NYSE also proposed to amend Section 303A.05(c) to adopt the specific requirements set forth in Rule 10C-1(b)(2) of the Exchange Act concerning a compensation committee's authority to engage compensation advisers, which must be set forth in the committee's charter. Specifically, the proposed amendment would endow the compensation committee with the power to, in its sole discretion, retain or obtain the advice of a compensation consultant, outside legal counsel or other adviser and to appoint, compensate and oversee such adviser. The company would have to provide for appropriate funding for the payment of reasonable compensation to the adviser.

The proposed rules would also require companies to consider the following independence factors outlined by the SEC in Rule 10C-1(b)(4) of the Exchange Act concerning the selection of a compensation consultant, legal counsel or any other adviser to the compensation committee:

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

Effective Dates and Transition Period

NYSE's proposed rules would become effective in two phases. First, proposed changes concerning compensation advisers would become effective on July 1, 2013. Second, 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 independence standards. After this time, the proposed rules would provide for a cure period for non-compliance that would allow for a member of the compensation committee who ceases to be independent for reasons outside of his reasonable control to remain on the committee until the earlier of the next annual meeting or one year from the occurrence of the event, so long as prompt disclosure is made to NYSE and a majority of the compensation committee remains independent.

However, NYSE proposes to continue to apply its existing transition periods under Section 303A.00 concerning compensation committee independence standards to companies: (i) listing in connection with an initial public offering or spin-off or carve-out, (ii) listing upon emergence from bankruptcy, (iii) previously registered under Section 12(g) of the Exchange Act or (iv) previously registered under Section 12(b) of the Exchange Act to the extent that the company's previous exchange did not have the same compensation committee requirements. Further, controlled companies, limited partnerships, funds registered under the Investment Company Act of 1940 and other companies currently exempt from NYSE's compensation committee requirements would remain exempt from the proposed rule changes. Smaller reporting companies would continue to be exempt from the compensation committee independence and compensation adviser independence requirements but would have to comply with the proposed rules concerning a compensation committee's authority to engage compensation advisers.

**NASDAQ Proposed Rules**

NASDAQ's proposed rule changes to Section 5605 of its Rules would require companies to: (i) have a standing compensation committee consisting of at least two independent directors and governed by a formal written charter, (ii) consider additional factors in assessing the independence of its compensation committee members and (iii) evaluate the independence of compensation committee advisers using the SEC's requirements set forth in Rule 10C-1(b)(4) of the Exchange Act.

Compensation Committee Requirements

Currently, NASDAQ does not require companies to have a compensation committee; instead a majority of the board's independent directors may make compensation decisions. NASDAQ's proposed rules would require a company to have a standing compensation committee with the authority and responsibility to determine, or recommend to the full board for the determination of, the compensation of the company's executive officers. The committee would consist of at least two members, each of whom would be independent directors as defined by NASDAQ Listing Rule 5605(a)(2). Further, a company would adopt a formal written charter to govern the compensation committee that details:

- The scope of the committee's responsibilities;
- The procedures by which the committee will carry out such responsibilities, including the structure of the committee, required processes and membership requirements;
- The committee's responsibility for determining, or recommending to the full board for the determination of, the compensation of all executive officers of the company, including the chief executive officer, who may not be present during the voting or deliberations concerning his compensation; and
- The specific compensation committee responsibilities and authority set forth in the proposed Rule 5605(d)(3), which requires that the committee have the specific responsibilities and authority necessary to comply with the SEC's Rule 10C-1(b)(2), (3) and (4)(i)-(vi) concerning compensation advisers, including the authority to retain and compensate compensation advisers and the responsibility to consider certain independence factors in selecting compensation advisers.

The compensation committee would review the charter annually for adequacy and compliance.

Compensation Committee Independence

Compensation committee members would meet further independence standards in addition to the director independence standards set forth by Rule 5605(a)(2). First, NASDAQ has proposed to adopt the same additional independence standards for compensation committee members that currently applies to audit committee members regarding compensatory fees. Specifically, compensation committee members would not accept, directly or indirectly, any consulting, advisory or compensatory fee from the company or its subsidiaries, except: (i) board service fees or (ii) fixed compensatory amounts received pursuant to a retirement plan for prior service to the company.

Second, in determining whether a compensation committee member is independent, a company's board of directors would consider the director's affiliations with the company, its subsidiaries or affiliates of subsidiaries. Rather than detailing a bright-line rule, NASDAQ would require an impairment analysis to determine if the affiliation would affect the director's judgment with regard to compensation committee duties. Unlike NASDAQ's audit committee analysis, a compensation committee member may be declared independent even if he is an affiliate.

Finally, NASDAQ does not propose to eliminate its existing "limited and exceptional circumstances" exception that allows non-independent directors to serve on compensation committees with at least three members under certain circumstances for up to two years. A company that relies on this exception must disclose this fact either on its website or in its next proxy statement.

Compensation Adviser Independence

Like the NYSE's proposed rules, NASDAQ's proposed rule change would adopt the specific requirements set forth in Rule 10C-1(b)(2) by the SEC concerning a compensation committee's authority to engage compensation advisers, which would be set forth in the committee's charter, as detailed above. Moreover, similar to the NYSE's proposed rules, the proposed changes would require companies to evaluate the independence of compensation committee advisers using the SEC's six factors set forth in Rule 10C-1(b)(4).

Effective Dates and Transition Period

NASDAQ's proposed rules would become effective in two phases. Proposed rules relating to a compensation committee's authority to engage compensation advisers and the adviser independence standards would become effective immediately upon SEC approval. However, listed companies would have until the earlier of: (i) their second annual meeting held following the approval of the proposed rules or (ii) December 31, 2014 to comply with the proposed rules requiring a standing, independent compensation committee with a formal charter. After this time, listed companies would be afforded a limited amount of time to cure any non-compliance with the compensation committee independence standards.

Like NYSE, NASDAQ's existing phase-in schedules for compensation committee independence standards would continue to apply with regard to the proposed rules for companies: (i) listing in connection with an initial public offering, (ii) emerging from bankruptcy, (iii) ceasing to be controlled companies and (iv) transferring from other markets. Further, NASDAQ proposes to maintain its existing exemptions from compensation-related listing standards for passive issuers, cooperatives, limited partnerships, management investment companies and controlled companies. Smaller reporting companies would be subject to the requirement to establish a standing compensation committee with a formal, written charter and the compensation committee authority rules, but would be exempt from the compensation committee independence and compensation adviser independence requirements.

**Actions to Consider**

Although all of the proposed rules remain subject to final approval by the SEC, companies should consider the following actions:

- Review and revise compensation committee charters to comply with the proposed rules;
- Review and revise Director and Officer's Questionnaires to reflect the new independence standards;
- Examine whether current compensation committee members will meet the heightened independence requirements and consider whether certain members should be replaced in light of the independence requirements;
- Examine whether existing policies for the evaluation of compensation advisers meet the new independence standards; and
- NASDAQ companies that do not currently have a compensation committee charter should begin the process of drafting and adopting a charter.

If you have any questions about this topic, please contact a member of our **Securities and Capital Markets Practice Group**.