Cooley

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As we discussed in our *Cooley Alert*, "**SEC Adopts New Rules for Compensation Committees, Consultants and Advisers**," issued in July 2012, the national securities exchanges were directed by the SEC, pursuant to the Dodd-Frank Wall Street Reform and Consumer Protection Act, to revise their listing standards to promote the independence of compensation committee members, consultants and advisers. However, the SEC afforded substantial flexibility for the exchanges, subject to ultimate SEC approval, to formulate definitions or other requirements consistent with the SEC's rules. The SEC required the exchanges to propose new listing standards by September 25 of this year. Both Nasdaq and the NYSE have submitted their proposals to the SEC with not a moment to spare.

Full NYSE proposal

Full Nasdaq proposal

As we noted in our July *Cooley Alert,* the SEC's rules closely tracked the provisions of Dodd-Frank without significant expansion, and both Nasdaq and the NYSE have largely followed suit.

However, there are some areas where the proposals of the two exchanges adopt divergent approaches, most significantly in connection with the rules regarding independence of compensation committee members. Under the SEC rules, exchange listing standards must require that each member of a compensation committee be independent. The exchanges' definitions of independence must be developed after taking into account relevant factors, including the following:

- The source of compensation of the director, including any consulting, advisory or other compensatory fee paid by the company to such director; and
- Whether the director is affiliated with the company, a subsidiary of the company or an affiliate of a subsidiary of the company.

While these special factors are similar to the special factors mandated for audit committee independence, unlike the audit committee composition requirements, the SEC did not mandate that failure to satisfy them would necessarily disqualify a member from serving on a compensation committee or otherwise provide any bright-line prohibitions.

NYSE proposal

In implementing the SEC requirements, the NYSE has likewise not proposed to include any bright-line tests in its definition of compensation committee independence, opting instead to modify the subjective component of its test for independence (contained in Section 303A.02 of the NYSE Listed Company Manual) to make special provision for compensation committees.

Currently, Section 303A.02 provides that no director qualifies as "independent" unless the board of directors makes an affirmative determination that the director has no material relationship with the listed company (directly or indirectly as a partner, shareholder or officer of an organization that has a relationship with the company). This broad determination requires the board to consider subjectively all of the facts and circumstances, keeping in mind the commentary currently in the Manual that "the concern is independence from management." Under the NYSE proposal, Section 303A.02(a) would be amended to specify that, in affirmatively determining the independence of any director who would serve on the compensation committee, the board "must consider all factors specifically relevant to determining 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,*" including, but not limited to, the two special factors identified above (emphasis added). In examining the director's sources of compensation, commentary to the proposed new provision would require the board to consider "whether the director receives compensation from any person or entity that would impair his ability to make independent judgments about the listed company's executive compensation." Similarly, with regard to affiliate relationships, the proposed commentary provides that the board should consider "whether the affiliate relationship 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 proposing release emphasizes that, in contrast to the mandatory audit committee rules, the NYSE does not intend to prohibit a board from making an affirmative finding that a director is independent solely on the basis that the director or the director's affiliates are shareholders owning more than some specified percentage of the listed company.

Nasdaq proposal

Nasdaq has taken a different approach in its proposal for compensation committee independence. Preliminarily, for the first time, Nasdaq is proposing, in light of "the heightened importance of compensation decisions in today's corporate governance environment," to modify its rules to require that listed companies have a dedicated compensation committee consisting of at least two directors, all of whom must be independent. (Currently, Nasdaq rules do not require a dedicated compensation committee, permitting listed companies as an alternative to provide that executive compensation decisions will be made, or recommended to the board, by independent directors who constitute a majority of all the independent directors.) The proposing release notes that only 25 of Nasdaq's listed companies would be affected by this change, as the vast majority of listed companies already have compensation committees.

While Nasdaq is not proposing to modify its definition of independence, the proposal would add two new eligibility requirements for compensation committee membership, one of which, in contrast to the NYSE rules, would include a bright-line prohibition that mimics current audit committee requirements. Nasdaq's proposal would absolutely prohibit a compensation committee member from accepting, directly or indirectly, any consulting, advisory or other compensatory fee from the listed company or any subsidiary (except for board or committee service or as deferred compensation for prior service under a retirement plan). Nasdaq concluded that there was "no compelling justification to have different independence standards for audit and compensation committee members with respect to the acceptance of compensatory fees."

In contrast, however, Nasdaq concluded (as did the NYSE) that there was "no compelling policy justification for precluding all affiliates, such as owners of a [c]ompany, even those with very large stakes" from serving as compensation committee members. Accordingly, the blanket prohibition that applies to affiliates' serving on audit committees is not proposed to apply to compensation committee members, and, as a result, a board "may conclude that it is appropriate for a director who is an affiliate to serve on the compensation committee." Nasdaq reasoned (as did the NYSE) that interests of some affiliates, such as representatives of significant shareholders, are likely aligned with those of other shareholders in seeking appropriate executive compensation programs. Although no bright-line standard is imposed in this context, in making eligibility determinations for compensation committee members, the board must specifically consider whether the director is affiliated with the company, a subsidiary of the company or an affiliate of a subsidiary of the company "to determine whether such affiliation would impair the director's judgment as a member of the compensation committee."

In neither case is there a "look-back" period, and, as a result, the board need only consider compensatory payments or affiliation with respect to relationships that occur during the director's service as a compensation committee member.

Other provisions in the NYSE and Nasdaq proposals

In most other significant respects, however, the exchanges' proposals are consistent with SEC rules. For example, although the SEC does not require compensation committees to select consultants, counsel or other advisers that are "independent," in making their selections, compensation committees must take into account six enumerated factors, each of which bears upon independence.[1] In their respective proposals, neither Nasdaq nor the NYSE would obligate listed companies to engage advisers or counsel that are independent, but instead would require only that compensation committees conduct independence assessments based on the same six factors identified by the SEC and, with regard to the NYSE, any other factors that would be relevant to the adviser's independence from management. Similarly, both of the exchanges echo the SEC's rules mandating that compensation committees have the authority, in their sole discretion, to retain compensation consultants, independent counsel and other advisers; be directly responsible for the appointment, compensation and oversight of their advisers' work; and be entitled to funding from the listed company to pay advisers' compensation. Both exchanges also provide for cure periods in the event that a member of a compensation committee ceases to be independent for reasons outside the member's control, although the NYSE would condition the availability of the cure period on the committee's otherwise continuing to have a majority of independent directors. In addition, Nasdaq would retain its current exception allowing a non-independent director who satisfies certain criteria to serve on the committee for up to two years under exceptional circumstances.

Effectiveness

Under SEC rules, the exchanges will have until June 27, 2013 to obtain final SEC approval of the new standards.

Under the NYSE proposal, listed companies would have until the earlier of their first annual meetings after January 15, 2014, or October 31, 2014, to comply with the new compensation committee independence standards. Other aspects of the NYSE proposal, including those related to compensation committee advisers, would become operative on July 1, 2013.

Under the Nasdaq proposal, the requirements relating to the responsibility and authority of compensation committees and the selection of compensation committee advisers would become effective immediately upon approval. Depending on state law, companies could impose these responsibilities and grant this authority through a charter, resolution or other board action. Ultimately, however, this authority must be included in the company's committee charter in accordance with the transition rules applicable to the remaining new provisions. Nasdaq proposes that companies must comply with the remaining provisions of the amended listing rules by the earlier of their second annual meeting held after the date of approval of Nasdaq's amended listing rules or December 31, 2014.

Observations and commentary

- For now, until listing standards are finalized, companies may want to make preliminary assessments as to whether their current compensation committee members would be compromised or run afoul of the proposed independence standards of the applicable exchange and begin to think about whether other directors are available to replace any directors who may be determined not to be independent for this purpose.
- Although it is clear that compensation advisers are not required to be independent and that committees need only consider the independence factors before selecting an adviser, it remains to be seen whether institutional shareholders, proxy advisory firms or other activists will pressure compensation committees into engaging only independent advisers. Committees may want to begin to consider what approach they will take in assessing the independence of both current and future advisers and whether they should adopt a formal or informal policy in that regard. The policy likely should include the committee's review of the policies of its advisers and prospective advisers to ensure that these advisers will be able to provide information requested by the committee and comply with any independence requirements imposed by the committee.
- Keep in mind that, under new SEC rules, if a compensation consultant played any role in determining or recommending the amount or form of executive or director compensation and the consultant's work has raised any conflict of interest, listed companies will now need to include disclosure in their annual meeting proxy statements regarding the nature of the conflict and

how it is being addressed. The disclosure requirement will be applicable to any proxy or information statement for an annual meeting of shareholders at which directors will be elected occurring on or after January 1, 2013, regardless of whether final listing standards have yet been adopted. As a result, committees may want to begin to identify, based on the six enumerated factors, any conflicts that may exist with their current compensation consultants and to consider how best to address those conflicts.

If you have any questions about this *Cooley Alert,* please contact one of your Cooley team members or one of the attorneys identified above.

NOTES

1 Before selecting a compensation consultant, legal counsel or other adviser, the compensation committee must take into consideration the following six factors:

- the provision of other services to the listed company by the adviser's employer;
- the amount of fees received from the listed company by the adviser's employer, as a percentage of the total revenue of the employer;
- the policies and procedures of the adviser's employer that are designed to prevent conflicts of interest;
- any business or personal relationship of the adviser with a member of the compensation committee;
- any stock of the listed company owned by the adviser; and
- any business or personal relationship of the adviser or the adviser's employer with an executive officer of the listed company.

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