

December 16, 2013

Nasdaq has just amended its rules related to compensation committee composition to bring them in sync with those applicable to NYSE companies. The rule changes took effect immediately. Nasdaq-listed companies are required to comply with the compensation committee composition aspects of the Nasdaq rules by the earlier of the first annual meeting after January 15, 2014, or October 31, 2014.

SEC Rule 10C-1, adopted under the Dodd-Frank Wall Street Reform and Consumer Protection Act, required the exchanges to adopt listing standards for compensation committee member independence mandating, as a baseline, that committee members be selected only after consideration of the "source of compensation of a member of the board of directors of an issuer, including any consulting, advisory or other compensatory fee paid by the issuer to such member of the board of directors." Each exchange was permitted to adopt rules that imposed additional or more exacting requirements. Only Nasdaq decided to exceed the minimal requirements. As a result, there was one key difference between the Nasdaq and NYSE compensation committee rules: Nasdaq *prohibited* the receipt of any compensatory fees from the company by compensation committee members (similar to the prohibition applicable to audit committee members), while the NYSE required only that compensation be considered as a factor. (For further discussion of the original and remaining Nasdaq rules related to compensation committee independence, see our *Cooley Alert*, "Final Nasdaq Rules for Compensation Committees and Compensation Consultants, Legal Counsel and Other Advisers," issued in February of this year. Since adoption of the rule, however, Nasdaq has received feedback from companies indicating that the prohibition on compensatory fees was too burdensome and that "this additional burden could influence a company's choice of listing venue." Not surprisingly, this competitive disadvantage led Nasdaq to replace the prohibition on the receipt of compensatory fees by committee members with the presumably more lenient requirement that the board instead *consider* the receipt of compensatory fees when determining committee eligibility.

The new changes make the Nasdaq rule remarkably similar to the NYSE rule. As amended, Nasdaq Rule 5605(d)(2)(A) provides that "in affirmatively determining the independence of any director who will serve on the compensation committee of a board of directors, the board of directors must consider all factors specifically relevant to determining whether a director has a relationship to the 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:

- i. the source of compensation of such director, including any consulting, advisory or other compensatory fee paid by the Company to such director; and
- ii. whether such director is affiliated with the Company, a subsidiary of the Company or an affiliate of a subsidiary of the Company."

Notably, the new test "clarifies" the importance of independence "from management," a concept that was emphasized in the NYSE listing standards, but was only implicit in the prior Nasdaq rules. (In addition, you may recall that, in the SEC's adopting release, the SEC suggested that the exchanges "might conclude" that the definition of independence should address business or personal relationships between a compensation committee member and executive officers of the listed company, although the SEC included no such mandate.) Similarly, the revised interpretive material (IM-5605-6) makes clear that the lens through which compensation must be evaluated is whether the compensation could affect judgments regarding executive compensation. The revised IM indicates that, "[w]hen considering the sources of a director's compensation for this purpose, the board should consider whether the director receives compensation from any person or entity that would impair the director's ability to make independent judgments about the Company's executive compensation." The revised interpretation also expands on the same concept when discussing the consideration of affiliate status: when considering affiliate relationships, "the board should consider whether the affiliate 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 the director's ability to make independent judgments about the Company's executive compensation."

The IM also notes that references to the "Company" must include any parent or subsidiary of the company, with the phrase "parent or subsidiary" intended to cover controlled and consolidated entities.

Interestingly, Nasdaq is also deleting the current exception from the definition of compensatory fees for fees received as a director or committee member and the receipt of fixed amounts of compensation under a retirement plan for prior service with the company. As a consequence, these fees, in aggregate with all other sources of compensation of the director from the company, would be considered in determining whether they might impair the director's judgment on the committee. This change was proposed to be consistent with the requirements of the other exchanges as well as in response to comments Nasdaq received during the rulemaking process. Several of these comment letters contended that boards should consider the fees paid to directors for their board or committee service, which, presumably, could also influence a director's judgments and independence from management. For example, the AFL-CIO argued in its comment letter that "[h]igh director fees relative to other sources of income can compromise director objectivity. Highly paid directors also may be more inclined to approve large executive pay packages."

Observations and commentary

- The amended rule may prove to be helpful for any Nasdaq-listed company that engages in a *de minimis* amount of business with one or more of its directors, which would have made those directors ineligible to serve on the compensation committee under the prior Nasdaq rules. The prior rule may have been a particular impediment for smaller companies that may have difficulty recruiting directors.
- The amended rule may not always prove to be more lenient than the prior rule, especially in light of the elimination of the exception for board and committee fees. The rule release maintains that, because committee members must also be independent under the general independence definition, boards of directors (or nominating and corporate governance committees) "would be required to consider, based on the company's and the director's unique circumstances, whether the receipt of any fees, even fees below [the \$120,000 annual caps set in the general independence definition], would impair the director's ability to make independent judgments about the company's executive compensation, and therefore render the director ineligible to serve on the compensation committee." (Note, however, that, in the general independence definition, the specific limitation related to the receipt of compensation expressly excludes directors' fees.) Now, companies that pay significant fees for service as directors, especially where the fees may constitute a substantial portion of a director's income, may find their boards (or their nominating and corporate governance committees) faced with the awkward task of inquiring into a director's financial resources to determine whether those fees could taint the director's independence from management and affect the director's perspective on executive compensation. Moreover, the expanded inquiry mandated by the amended rule will now require the board (or nominating and corporate governance committee) to take into account "all factors specifically relevant" to determining whether the director's independence from management in connection with the duties of a compensation committee member may be impaired by any relationship of the director to the company and to consider receipt by the director of compensation from any other person or entity (not just the company) that would impair the director's ability to make independent judgments about the company's executive compensation. While the typical D&O questionnaire will generally ask for this information, boards (or nominating and corporate governance committees) will be required to specifically focus their attention in this area with respect to selection of compensation committee members.
- Nasdaq-listed companies should review their compensation committee charters, director qualification policies and related materials to update them as appropriate to reflect the rule change. No change to the charter should be required to the extent that it refers only to the independence requirements of the Nasdaq Stock Market applicable to compensation committee members, as in effect from time to time.

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

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