February 8, 2013

In January of this year, the SEC finally approved the new listing standards proposed by Nasdaq for independent compensation committees and compensation consultants, legal counsel and other advisers. These new listing standards, adopted as required under the Dodd-Frank Wall Street Reform and Consumer Protection Act and the SEC's implementing Rule 10C-1 under the Securities Exchange Act of 1934, are designed to promote the independence of compensation committee members, consultants and advisers. The SEC established a baseline of considerations for determining the independence of compensation committee members and consultants, but afforded substantial flexibility for the exchanges, subject to ultimate SEC approval, to formulate definitions or other requirements consistent with the SEC's rules. For the most part, the new Nasdaq listing standards adhere closely to the SEC's baseline and are largely congruent with the contemporaneously adopted new NYSE listing standards. In any case, application of the rules will raise interesting issues as boards of directors and compensation committees grapple with questions of whether potential conflicts of interest or other independence concerns should necessarily result in disqualification from service.

Listed companies will have until the earlier of their first annual meeting after January 15, 2014, or October 31, 2014, to comply with compensation committee member independence requirements, as well as all other provisions of the new listing standards. Accordingly, for calendar-year reporting companies, these rules will not have any impact on the 2013 proxy season. Listed companies will, however, be required to establish the committee's authority and responsibility regarding compensation consultants and advisors in their committee charters or by resolution or other board action by July 1, 2013.

SEC Rule 10C-1

SEC Rule 10C-1 directs the exchanges to adopt listing standards for public company boards of directors and compensation advisers that address the following:

- The independence of the members of a compensation committee;
- The committee's authority to retain compensation advisers;
- The committee's consideration of the independence of any compensation advisers; and
- The committee's responsibility for the appointment, compensation and oversight of the work of any compensation adviser.

Additional eligibility factors applicable to compensation committee members

As directed by SEC rules, Nasdaq's listing standards will now require that, in addition to being independent, each member of a compensation committee must also satisfy two additional eligibility criteria. (In addition, although neither Dodd-Frank nor the SEC required this change, Nasdaq will now require that each listed company have a compensation committee, consisting of at least two directors. Only approximately 25 companies will be affected by this change.)

Under current Nasdaq listing standards, each member of a listed company's compensation committee must be independent. Nasdaq currently employs a two-part test for independence: in addition to several enumerated bright-line tests, the board must make an affirmative determination that the director has no relationship that, in the opinion of the board, would interfere with the exercise of independent judgment in carrying out the responsibilities of a director. This standard will remain unchanged. However, in determining eligibility to serve on the compensation committee, boards of listed companies will now also need to take into account two additional eligibility factors:

- A prohibition against acceptance, directly or indirectly, by any compensation committee member of any consulting, advisory or other compensatory fee from the listed company or any subsidiary of the listed company (referred to as the "Fees Factor").
- Whether the director is affiliated with the listed company, a subsidiary of the listed company or an affiliate of a subsidiary of

the listed company (referred to as the "Affiliation Factor").

Nasdaq determined not to impose any additional eligibility factors for service on the compensation committee.

Additional eligibility requirement—the fees factor

Currently, Nasdaq rules would permit directors who receive from the listed company compensatory fees below enumerated bright line thresholds to serve on the company's compensation committee. However, in light of the prohibition against acceptance of compensatory fees applicable to audit committee members, Nasdaq concluded that "there is no compelling justification to have different independence standards for audit and compensation committee members with respect to the acceptance of compensatory fees." Accordingly, Nasdaq's new listing standard (in contrast to the NYSE listing standard) contain an absolute prohibition on the acceptance, directly or indirectly, by a compensation committee member of any consulting, advisory or other compensatory fee from the listed issuer or any subsidiary (except fees for board or committee service or fixed, non-contingent amounts (including deferred compensation) payable under a retirement plan for prior service). There is no look-back period applicable, so that the prohibition would apply only during the director's term of service on the committee.

Additional eligibility requirement—the affiliation factor

Currently, Nasdaq's definition of independence does not expressly refer to affiliation, although the definition does exclude certain individuals who may be considered affiliates. In contrast to its conclusion with respect to compensatory fees, Nasdaq concluded that, with respect to the Affiliation Factor, "such a blanket prohibition would be inappropriate for compensation committees." Accordingly, the blanket prohibition that applies to affiliates' serving on audit committees is not applicable to compensation committee members, and a board may conclude that it is "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." Although no bright-line standard is imposed, in making eligibility determinations for compensation committee members, boards must specifically consider whether the affiliation "would impair the director's judgment as a member of the compensation committee." Again, there is no "look-back" period, and, as a result, the board need only consider affiliation with respect to relationships that occur during the director's service as a compensation committee member.

Observations and commentary

- Although the compensation committee independence requirements will not become operative until 2014, companies should begin now to make assessments as to whether their current compensation committee members would be compromised or raise concerns under the independence/eligibility standards for compensation committee members and consider whether other directors are available to replace any directors who may be determined not to be eligible for this purpose. The absolute prohibition on receipt of any compensatory fees from the listed company or its subsidiaries may have a disproportionate impact on smaller companies that have smaller boards and fewer resources. Although the new standards do not impose a mandatory disqualification if the Affiliation Factor is not satisfied, it remains to be seen whether institutional shareholders or proxy advisory firms, such as ISS and Glass Lewis, will *de facto* impose disqualification by withholding votes for compensation committee members and other tactics. At least one of the commenters on the Nasdaq proposal advocated a ban on allowing affiliates to serve on the compensation committee, arguing that affiliated persons "may have interests or investment time horizons that differ from shareholders generally." Boards may want to develop their own internal (formal or informal) policies that address, in addition to the Fees Factor, the consequences of circumstances that implicate the Affiliation Factor.
- Several commenters contended that the new standards should be more explicit in requiring the board to consider, as part of its consideration of the Affiliation Factor, personal or business relationships with management. One commenter believed that "too many corporate directors have significant personal, financial or business ties to the senior executives that they are responsible for compensating." However, Nasdaq did not believe that further clarification was necessary given that Nasdaq requires boards to affirmatively determine that each independent director has no relationship that, in the opinion of the board, would interfere with his or her independent judgment in carrying out director responsibilities. This provision, Nasdaq contended, empowers boards to assess the relevant relationships.
- The proposal received several comments suggesting that, because excessive board fees could also impair independence and incline a director toward approval of large executive pay packages, board fees (as well as compensation from other third parties) should also be considered as a "source of compensation" in determining whether a committee member has satisfied

the Fees Factor. Nasdaq rejected that idea as unlikely to be relevant since all outside directors are eligible for the same fees, and thus the requirement would not lead to meaningful distinctions among directors. Nasdaq also noted that, because companies must disclose director compensation, investors will become aware of compensation that is excessive. In addition, to the extent that excessive board compensation might affect independence, the listing standard would require that the board consider compensation as one of the relevant factors in making its affirmative determination that each independent director has no relationship that, in the opinion of the board, would interfere with his or her independent judgment in carrying out director responsibilities.

Committee composition—exceptional and limited circumstances exception

Nasdaq proposes to retain its existing exception that allows a non-independent director to serve on the compensation committee under exceptional and limited circumstances. This exception would be available for a director who fails the new independence/eligibility requirements. Under this exception, if a compensation committee consists of at least three members, one director who is not independent/eligible, but is not an executive officer, employee or family member of an executive officer may serve on the compensation committee for up to two years if the board, under exceptional and limited circumstances, determines that the director's service on the committee is required by the best interests of the company and its stockholders. Companies relying on the exception must disclose their reliance on the exception and describe on their websites or in their proxy statements the nature of the relationship and the reasons for the determination.

Committee composition—cure period

If a listed company fails to comply because it has one vacancy on the compensation committee, or one committee member ceases to be independent due to circumstances beyond the member's reasonable control, the company has a "cure period," during which it must regain compliance, until the earlier of the next annual stockholders meeting or one year from the occurrence of the event that caused the noncompliance. However, if the annual stockholders meeting occurs no later than 180 days following the event that caused the noncompliance, the company will have instead 180 days from the event to regain compliance, thus providing least 180 days to cure noncompliance. Immediate notice to Nasdaq is required. (Note that the reference in the rules is just to "independence," but presumably Nasdaq intended to include the other eligibility requirements as part of the reference.)

Compensation committee charter

Under the new listing standards, each listed company will now be required to certify that it has adopted a formal written compensation committee charter and that the compensation committee will review and reassess the adequacy of the formal written charter annually. The new listing standards also require that the specific new responsibilities and authority be included in the compensation committee charters of listed companies with respect to compensation consultants, legal counsel and other advisers. The charter must specify the following:

- 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 CEO and all other executive officers;
- that the CEO may not be present during voting or deliberations by the compensation committee on his or her compensation; and
- specific responsibilities and authority relating to consultants, legal counsel and advisers providing that the compensation committee must be:
    - authorized, in its sole discretion, to retain or obtain the advice of compensation consultants, legal counsel and other advisers;
    - directly responsible for the appointment, compensation and oversight of the work of compensation consultants, legal counsel and other advisers retained by the committee; and
    - entitled to appropriate funding from the listed company to pay reasonable compensation to the committee's compensation consultants, legal counsel and other advisers.
    - authorized to select, or receive advice from, a compensation consultant, legal counsel or other adviser to the compensation committee, other than in-house legal counsel, only after taking into consideration specified

independence factors (discussed below).

Independence assessment of compensation consultants, legal counsel and other advisers

Nasdaq's new listing standard provides that, although compensation committees are not required to select compensation consultants, legal counsel or other advisers that are "independent," they must, in making their selections, take into account the following six factors, which bear upon independence:

- 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.

Nasdaq concluded that these six independence factors (which are identical to those enumerated in SEC rules) were adequate and did not propose any additional factors.

Compensation committees must conduct independence assessments with respect to any compensation consultant, legal counsel (other than in-house legal counsel) or other adviser that provides advice to the compensation committee—even if not expressly engaged as an adviser or counsel to the committee—unless his or her role is limited to the following activities (for which no disclosure would be required under Item 407(e)(3)(iii) of Regulation S-K) :

- consulting on any broad-based plan that does not discriminate in scope, terms or operation in favor of executive officers or directors of the listed company, and that is available generally to all salaried employees; or
- providing information that either is not customized for a particular company or that is customized based on parameters that are not developed by the compensation consultant, and about which the compensation consultant does not provide advice.

These excepted activities are not viewed by Nasdaq to raise conflict-of-interest concerns. Notably, this requirement is "not limited to advice concerning executive compensation." The SEC anticipates that compensation committees will conduct these independence assessments at least annually.

Nothing in the new listing standards requires the compensation committee "to implement or act consistently with the advice or recommendations of the compensation consultant, legal counsel or other adviser to the compensation committee" or affects the "ability or obligation of a compensation committee to exercise its own judgment" in fulfillment of its duties.

The new listing standard also emphasizes that nothing in the new standard "requires a compensation consultant, legal counsel or other compensation adviser to be independent, only that the compensation committee consider the enumerated independence factors before selecting, or receiving advice from, a compensation adviser. Compensation committees may select, or receive advice from, any compensation adviser they prefer, including ones that are not independent, after considering the six independence factors…."

Observations and commentary

- 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, whether institutional shareholders, proxy advisory firms or other activists will pressure compensation committees into engaging only independent advisers remains an open question. Committees may want to begin to consider what principles will guide them 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 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.
- Listed companies will need to review and revise their compensation committee charters before the July 1, 2013 deadline to

ensure that they are compliant with the listing standards (or take other action to establish committee authority and responsibility). While most compensation committee charters authorize the engagement of consultants, counsel and advisers, including funding by the company, few charters will provide for the independence assessment now required under the new listing standards. Compensation committees will also need to ensure that this assessment (which may involve review of standard questionnaires) becomes part of their regular policies and procedures before selecting new advisers or even receiving advice from any current or future consultants, counsel or advisers.

- 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 beginning with the 2013 proxy season. As a result, companies will need to identify, based on the six enumerated factors, any conflicts that may exist with their current compensation consultants and consider how best to address those conflicts. Notably, this disclosure requirement does not apply to legal counsel or other advisers.
- The requirement to assess independence is applicable to any compensation consultant or legal counsel (other than in-house counsel) or other adviser that provides advice to the compensation committee, even if not expressly engaged as an adviser or counsel to the committee. For example, the assessment must be performed by the committee with respect to regular outside counsel, presumably including the company's regular securities or tax counsel to the extent they give advice to the compensation committee, as well as compensation consultants or other advisers retained by management or the company.

Smaller reporting companies

Although smaller reporting companies will be required to have a compensation committee composed of at least two independent directors, independence will be defined under Nasdaq's existing listing standards, and smaller reporting companies will not need to adhere to the new eligibility requirements relating to the Fees Factor or the Affiliation Factor. Similarly, smaller reporting companies will be required to adopt a formal written compensation committee charter or board resolution that includes the same content as other companies; however, they will not need to incorporate into their charters or board resolutions provisions regarding authority to retain and fund compensation consultants, counsel and advisers and responsibility to consider the independence of compensation consultants, counsel and advisers, nor will they be required to review and reassess the adequacy of the charter or board resolutions annually.

Exemptions

The categories of listed companies that are exempt from Nasdaq's current compensation-related listing standards will also be exempt under the new standards. These include, among others, exemptions for asset-backed issuers and other passive issuers, cooperatives, limited partnerships, management investment companies and controlled companies (defined as companies in which more than 50% of voting power in the election of directors is held by an individual, a group or another company). Foreign private issuers will continue to be allowed to follow their home country practices in lieu of Nasdaq's revised listing rules relating to compensation committees so long as they disclose annually the reasons that they do not have independent compensation committees, and describe the requirements that they do not follow, as well as the home country practices that they do follow.

Phase-in schedules

The existing phase-in schedules (generally, permitting a gradual step-by-step transition to a completely independent committee within one year of listing) for companies listing in connection with an IPO, companies emerging from bankruptcy and companies ceasing to be controlled companies will continue under the new listing standards. These schedules allow phase-in compliance with the minimum size and independent committee requirement as well as the additional eligibility requirements applicable to compensation committee members.

A company that ceases to be a smaller reporting company will have a slightly different phase-in schedule that also leads to an independent compensation committee that satisfies the additional eligibility factors within one year of the date that the company ceases to be a smaller reporting company under SEC rules (the beginning of

the fiscal year after its public float equals or exceeds $75 million). Companies that cease to be smaller reporting companies would also need to comply with the requirement relating to adoption of a formal written charter, the authority to retain and the funding of compensation committee advisers, as well as the responsibility to assess the independence of compensation committee advisers, within six months of that cessation date.

Effective dates/transition

By July 1, 2013, listed companies will be required to comply with the provisions of the new listing standards relating to the authority of a compensation committee to retain and fund compensation consultants, legal counsel, and other compensation advisers, as well as the responsibility of the committee to assess their independence. Depending on state law, companies could impose these responsibilities and grant this authority through a charter provision, resolution or other board action. Ultimately, however, this authority must be included in the listed company's committee charter in accordance with the transition rules applicable to the remaining new provisions. Listed companies will have to comply with the remaining new provisions, including the compensation committee composition requirements, by the earlier of their first annual meeting after January 15, 2014, or October 31, 2014.

Companies will be required to certify (on a form provided by Nasdaq) to Nasdaq, within 30 days after the applicable final implementation deadline that they have complied with the amended listing rules on compensation committees.

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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