Exchanges Propose Compensation Committee Independence Standards

No New Bright-Line Tests Under NYSE Proposal; Nasdaq Proposal Would Prohibit All Compensatory Fees Other Than Director Fees and Require Formal Compensation Committee and Written Charter

SUMMARY

Certain U.S. securities exchanges have filed with the SEC proposed revisions to their equity listing standards regarding compensation committee and compensation adviser independence, as required by SEC rules issued under the Dodd-Frank Wall Street Reform and Consumer Protection Act.

The New York Stock Exchange proposal would not impose any new bright-line tests on compensation committee members, but would include additional considerations for the board’s subjective independence determination. The proposal by the Nasdaq Stock Market would impose a new bright-line test for compensation committee members by prohibiting their receipt of any compensatory fees from the company other than director fees and fixed payments for prior service. In addition, Nasdaq would, for the first time, require listed companies to have a standing compensation committee consisting of at least two independent directors and a formal written compensation committee charter. Both the NYSE and Nasdaq proposals confirm that being, or being affiliated with, a significant stockholder would not be a bar to service on the compensation committee.

In addition, as contemplated by the statute and the SEC rules, both the Nasdaq and NYSE proposals require that compensation committees have broad authority, and adequate funding, to engage advisers, and that compensation committees consider certain independence factors before engaging a compensation consultant, independent legal counsel or other adviser. These responsibilities must be reflected in the committee charter.
The stock exchange proposals have not yet been published by the SEC for public comment, and are ultimately subject to SEC comment and approval. In the past, the SEC has sought to harmonize differences in stock exchange governance listing standards and it may seek to do so here. SEC rules require the new listing standards to be approved by the SEC by June 27, 2013. Neither proposal is expected to affect the 2013 proxy season, although the Nasdaq changes relating to compensation committee responsibilities and authority would be effective immediately on SEC approval.

These proposals are separate from the SEC’s proxy disclosure requirements adopted in June 2012 relating to compensation consultants’ conflicts of interest. Those requirements are imposed by SEC rules and will take effect for meetings in 2013.¹

BACKGROUND
Section 952 of the Dodd-Frank Act directed the SEC to issue rules requiring national securities exchanges to:

- prohibit the listing of any equity security unless each member of the issuer’s compensation committee is “independent”;
- require compensation committees to consider the independence of any compensation advisers; and
- require listed companies to disclose any conflicts of interest of compensation advisers and give compensation committees the authority and funding to engage independent advisers.

On June 20, 2012, the SEC adopted Rule 10C-1 under the Securities Exchange Act of 1934, which largely tracks the statute and leaves most of the details of the relevant independence standards to the exchanges to propose. National securities exchanges were directed to submit proposed listing standards by September 25, 2012, and must have final rules approved by the SEC no later than June 27, 2013.

The NYSE, Nasdaq and certain other securities exchanges posted their respective rule proposals on their respective websites on September 25, 2012.²

¹ For a further discussion of these disclosure requirements, as well as SEC Rule 10C-1, see our publication dated June 22, 2012, entitled “SEC Finalizes Guidance to Stock Exchanges on Compensation Committee and Adviser Independence.”

² The NYSE subsequently amended their proposal to correct the transition period, as described under “Timing and Implementation of Proposals” below. This publication focuses on the proposals issued by the NYSE and Nasdaq, as these represent the vast majority of common stock listings in the U.S. There are currently 14 other national securities exchanges registered under Section 6(a) of the Exchange Act: NYSE MKT, BATS Exchange, BATS Y-Exchange, BOX Options Exchange, C2 Options Exchange, Chicago Board Options Exchange, Chicago Stock Exchange, EDGA Exchange, EDGX Exchange, International Securities Exchange, NASDAQ OMX BX, National Stock Exchange, NYSE Arca and NASDAQ OMX PHLX.
EXCLUSIONS FOR NON-U.S. LISTED COMPANIES AND OTHER ISSUERS

Both the NYSE and Nasdaq have proposed to exempt foreign private issuers from the new requirements, to the same extent that they are exempt from the other corporate governance listing standards. Specifically, a foreign private issuer that follows home country practices is automatically exempt from the relevant requirements if the issuer discloses, in its annual report to shareholders or on its website, any significant ways in which its corporate governance practices differ from those followed by domestic companies under applicable listing standards. The exemption proposed by the NYSE is broader than that contemplated in the statute and the SEC rule, in that foreign private issuers would not need to disclose in their annual report the reason why they do not have an independent compensation committee; however, the Nasdaq proposal would require such disclosure.

Furthermore, companies that are currently exempt from the compensation committee and independence requirements under NYSE or Nasdaq rules would continue to be exempt under the proposed standards. This would include, among others, controlled companies, certain passive issuers, limited partnerships, investment companies and companies in bankruptcy.

Finally, the NYSE and Nasdaq proposals would exempt smaller reporting companies (as defined in SEC rules) from the heightened independence standards and the new requirements relating to compensation consultants, independent legal counsel and other compensation advisers, in light of the fact that Rule 10C-1 does not apply to these companies. Smaller reporting companies would, however, be subject to:

- the existing governance listing standards, including the requirement that compensation committee members be independent directors, as currently defined;
- the proposed Nasdaq requirement for a standing compensation committee with a formal written charter; and
- proposed NYSE requirements with respect to the compensation committee’s authority and funding to engage compensation advisers, but not the requirement to consider certain enumerated independence factors.

DETAILS OF NYSE PROPOSAL

Compensation Committee Director Independence Requirements. The NYSE does not propose any new bright-line tests applicable to compensation committee members. The NYSE proposes to adopt a new subsection to its director independence standards set forth in Section 303A.02 that would require the board to consider all factors specifically relevant to determining whether a compensation committee member has a relationship to the listed company that is material to that director’s ability to be independent from management in connection with the duties of a compensation committee member. Commentary to the proposed rule states that, while it is not possible to anticipate all circumstances that might signal a potential conflict of interest, the board should consider at least the following two factors:
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- The source of the director’s compensation – specifically, 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.

- Whether the director has an affiliate relationship with the company, a subsidiary or an affiliate of a subsidiary – specifically, whether any 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 listed company’s executive compensation.

In addition, the NYSE’s proposal makes clear that the board may determine that a compensation committee member is independent despite the director, or an affiliate of the director, having a significant stock position in the company. The proposal states the NYSE’s belief that “share ownership in the listed company aligns the director’s interests with those of unaffiliated shareholders, as their stock ownership gives them the same economic interest in ensuring that the listed company’s executive compensation is not excessive.”

Compensation Committee Advisers. The NYSE proposes to adopt the requirements set forth in Rule 10C-1(b)(2) and (3), which require that the compensation committee have broad authority to engage advisers, and the company provide for appropriate funding, as determined by the compensation committee, for payment of reasonable compensation to an adviser. In addition, the NYSE’s proposal would require a compensation committee, before engaging a compensation consultant, independent legal counsel or other advisers (other than in-house legal counsel), to consider the independence factors enumerated in Rule 10C-1(b)(4).  

These provisions regarding the authority and responsibility of the compensation committee must be set forth in the committee’s charter.

Cure Periods. As contemplated by Rule 10C-1(a)(3), the NYSE proposal provides that if a member of a compensation committee ceases to be independent for reasons outside the director’s reasonable control, that person may remain a member of the compensation committee until the earlier of the next annual meeting or one year from the occurrence of the event resulting in a lack of independence. 

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3 The factors that must be considered include: (a) the provision of other services to the listed company by the person that employs the compensation consultant, legal counsel or other adviser; (b) the amount of fees received from the listed company by the person that employs the compensation consultant, legal counsel or other adviser, as a percentage of the total revenue of the person that employs the compensation consultant, legal counsel or other adviser; (c) the policies and procedures of the person that employs the compensation consultant, legal counsel or other adviser that are designed to prevent conflicts of interest; (d) any business or personal relationship of the compensation consultant, legal counsel or other adviser with a member of the compensation committee; (e) any stock of the listed company owned by the compensation consultant, legal counsel or other adviser; and (f) any business or personal relationship of the compensation consultant, legal counsel, other adviser or the person employing the adviser with an executive officer of the listed company.

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October 2, 2012 (revised)
provides, however, that the cure period would only apply if the compensation committee continues to have a majority of independent directors.

**DETAILS OF NASDAQ PROPOSAL**

*Requirement for Compensation Committee.* Unlike the NYSE, the current Nasdaq listing standards do not require listed companies to have a standing compensation committee or a formal committee charter, though it is common practice for Nasdaq-listed companies to have them. Nasdaq listing standards currently permit executive compensation oversight by either a compensation committee comprised solely of independent directors or a vote of a majority of the independent directors. Nasdaq’s proposal would delete this second alternative and require listed companies to have a standing compensation committee consisting of at least two members.

*Committee Charter and Consultant Independence.* A listed company would also 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 on an annual basis. Specifically, the charter must specify:

- the scope of the committee’s responsibilities and how it carries out such responsibilities;
- the committee’s responsibility for determining, or recommending to the board for determination, the compensation of the executive officers of the company;
- that the chief executive officer may not be present during voting or deliberations by the committee on such individual’s compensation; and
- the specific compensation committee responsibilities and authority set forth in Rule 10C-1(b)(2), (3) and (4)(i)-(iv) relating to:
  - the committee’s authority to retain compensation consultants, independent legal counsel and other compensation advisers;
  - the committee’s ability to pay such advisers; and
  - the committee’s responsibility to consider certain specified independence factors before selecting advisers other than in-house legal counsel.  

*Compensatory Fees for Committee Members.* Rule 10C-1 requires that exchanges consider, among other factors, the source of compensation of a compensation committee member in determining independence. To address this consideration, Nasdaq proposes to adopt the same standard applicable to audit committee members under SEC Rule 10A-3 and prohibit a compensation committee member from directly or indirectly accepting any consulting, advisory or other compensatory fee from the issuer or any subsidiary during the member’s term on the compensation committee. Consistent with SEC Rule 10A-3, “compensatory fees” would not include:

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4 These factors are set out in note 3 above.
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- fees received as a director or committee member; or
- fixed amounts of compensation under a retirement plan, including deferred compensation, for prior service with the company, provided that such compensation is not contingent on continued service.

Also, like Rule 10A-3, the proposed rule would not have a “look-back” requirement; only compensatory fees received while a member of the compensation committee would impair independence.

Affiliation of Committee Members. Nasdaq proposes to require listed companies’ boards to consider whether a director is affiliated with the company, a subsidiary of the company or an affiliate of a subsidiary of the company when determining whether any affiliation would impair the director’s independence. No bright-line rules apply in making the determination, and the board is not required to consider affiliations that occurred prior to the individual’s term of service as a compensation committee member. Moreover, a board may appropriately conclude that a director who is an affiliate meets the independence standards required to serve on the compensation committee. The proposal states Nasdaq’s view that “it may be 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.”

Exceptional and Limited Circumstances. The Nasdaq proposal retains the current exception that permits a non-independent director to serve on the compensation committee under exceptional and limited circumstances, even if the director fails to meet the requirements proposed pursuant to Rule 10C-1. Under the proposal, a director who is not independent and is not an executive officer, employee or family member of an executive officer may serve on the compensation committee if:

- the compensation committee consists of at least three members;
- the board, under exceptional and limited circumstances, determines that membership on the compensation committee is required by the best interests of the company and its shareholders;
- the company discloses, either on the company’s website or in the proxy statement for the next annual meeting of shareholders, the nature of the relationship and the reasons for the board’s determination;
- the company discloses its reliance on the exemption in its proxy statement as required by Instruction 1 to Item 407(a) of Regulation S-K; and
- the director does not serve on the compensation committee for more than two years.

Cure Periods. As contemplated by Rule 10C-1(a)(3), the Nasdaq proposal provides that if a member of a compensation committee ceases to be independent for reasons outside the director’s reasonable control, that person may remain a member of the compensation committee until the earlier of the next annual meeting or one year from the occurrence of the event resulting in a lack of independence. Nasdaq would further expand the cure to also apply to situations where the company fails to comply with compensation committee rules due to a vacancy, and would further provide that the cure period would extend for a minimum of 180 days (even if the next annual meeting occurs before that).
TIMING AND IMPLEMENTATION OF PROPOSALS

The stock exchange proposals are subject to public comment and SEC approval.

The NYSE has proposed that companies must comply with the new compensation committee independence standards by the earlier of (a) the first annual meeting after January 15, 2014 or (b) October 31, 2014. The other proposed changes, including the expanded compensation committee responsibilities with respect to advisers, would take effect on July 1, 2013.\(^5\)

Nasdaq would require their proposed rule changes relating to compensation committee responsibilities and authority to be effective immediately upon SEC approval. The proposal states that, to the extent a company does not have a compensation committee, the rule would apply to the independent directors who determine, or recommend to the board for determination, executive compensation. Companies would be required to comply with the remaining proposed provisions, including the compensation committee independence requirements and the requirement to adopt a written compensation committee charter, by the earlier of (a) the second annual meeting held after the date the rules are approved or (b) December 31, 2014.

Under both the NYSE and Nasdaq proposals, the compensation committee independence requirements would be subject to the existing transition periods applicable in the case of initial public offerings, companies listing in connection with a spin-off or carve-out, companies emerging from bankruptcy, and companies that cease to qualify as controlled companies or foreign private issuers.

IMPLICATIONS AND NEXT STEPS

Although the compensation committee independence requirements remain subject to public comment, SEC approval and the transition periods described above, issuers may want to consider revising their year-end Director and Officer Questionnaires to obtain additional information about relationships between compensation committee members, compensation advisers and the listed company and its subsidiaries and executive officers. The revised Questionnaires would need to solicit information from both the members of the compensation committee and executive officers. Likewise, issuers may want to develop questionnaires for compensation committee advisers and begin obtaining information from them as well. Moreover, any Nasdaq-listed company that has not yet adopted a compensation committee charter may wish to begin the process of preparing a charter and moving through the approval process, and companies that have adopted a compensation committee charter may wish to begin considering the manner in which the charter would need to be updated upon adoption of the new rules. We would be

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\(^5\) The NYSE’s initial proposal stated that the extended deadline was to apply to all of the provisions of the rule. This was corrected in a subsequent amendment to the proposal.
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pleased to assist clients in revising their Director and Officer Questionnaires, preparing a compensation adviser questionnaire or preparing a new or revised compensation committee charter.

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Exchanges Propose Compensation Committee Independence Standards
October 2, 2012 (revised)
SC1:3309857.5