SULLIVAN & CROMWELL LLP

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SEC Approves Nasdaq Rule Requiring Disclosure of Third-Party Compensation to Director Candidates

Reflects Continued Focus on Activist Payments to Directors and Nominees; Nasdaq Notes Potential for Conflicts of Interest, Fiduciary Duty Concerns and Promotion of Short-Term Focus

SUMMARY

The U.S. Securities and Exchange Commission has approved a Nasdaq Stock Market Rule requiring all Nasdaq-listed U.S. companies to disclose annually, either on their website or in their annual proxy statement, any agreements or arrangements between any third party and a director or nominee providing for compensation or other payments in connection with the person's candidacy or service as a director. Nasdaq notes its concerns that investors "may not have complete or timely information" about these types of arrangements and that these arrangements could lead to conflicts of interest among directors, call into question their ability to satisfy their fiduciary duties and promote a focus on short-term results at the expense of long-term value creation. The concerns underlying this Rule change are similar to those that have caused a number of public companies to address the issue of third-party director or nominee compensation in their bylaws, by either requiring disclosure to the company of such arrangements or prohibiting them.

Nasdaq also states that it is separately surveying interested parties as to whether it should propose additional requirements surrounding directors and nominees that receive third-party payments, including whether such directors should be prohibited from being considered independent under Nasdaq rules or serving on the board altogether.

The new Rule will become effective 30 days after the date of SEC approval, which was July 1, 2016.[1] No immediate disclosure is required as of the effective date – the disclosure will be required no later than the date of the proxy statement or information statement for the next shareholders' meeting after the effective date at which directors are elected (or, if the listed company does not file proxy or information statements, no later than the company's next Form 10-K or Form 20-F filing).

A listed foreign private issuer may follow its home country practices in lieu of the new disclosure requirement, but must disclose in its Form 20-F or on its website that it does not follow the new requirement and the home country practice that it does follow.

Companies should examine their most recent director questionnaires to confirm that they are worded broadly enough to elicit the information required to be disclosed by the new Rule. If they are not, companies should take appropriate steps to confirm whether any disclosure will be needed.

BACKGROUND

Third-party compensation of public company directors and director candidates has been a focus of concern in recent years, as certain activists have developed a practice of putting in place potentially lucrative arrangements to induce individuals to serve as the activist's director nominee, either in a proxy contest or as part of a settlement with the company. In some cases, as noted in the Nasdaq filing, these arrangements include incentives for achieving benchmarks, such as an increase in stock price over a fixed term. While a one-time, relatively modest fee for agreeing to be nominated in a proxy contest has been common, other types of arrangements – particularly those that continue during the individual's tenure as director – have raised significant concerns among market participants that they give directors financial incentives that may align their interests with a particular investor or set of investors and not with the longer-term best interests of the company and its shareholders more broadly.

Although there are various SEC disclosure rules that would, in some circumstances, cover these arrangements, the SEC's disclosure regime may not always provide timely and complete information to investors.[2] For this reason, some companies have included provisions in their bylaws requiring director

1 *See* SEC Rel. No. 34-78223 (July 1, 2016), 81 Fed. Reg. 44400 (July 7, 2016) available at https://www.sec.gov/rules/sro/nasdaq/2016/34-78223.pdf. Nasdaq's filing with the SEC, File No. SR-NASDAQ-2016-013, Amendment No. 2, containing the text of the new Rule is available at http://nasdaq.cchwallstreet.com/NASDAQ/pdf/nasdaq-filings/2016/SR-NASDAQ-2016-013_Amendment_2.pdf.

2 For example, Item 402(k) of Regulation S-K requires proxy disclosure of all compensation paid to directors in the last fiscal year for service as a director, including compensation from third parties. This, however, would not apply to new nominees or to payments made in the current year. Item 401(a) of Regulation S-K requires proxy disclosure of any "arrangement or understanding" between a director or nominee and any other person "pursuant to which he was or is to be selected as a director or nominee," but an instruction provides that no disclosure is needed with respect to "directors or officers of the registrant acting solely in their capacities as such."

candidates to provide information to the company as to any compensatory arrangements with third parties, and many are simply requesting this information in the questionnaires sent to directors and nominees. This enables the company to identify and make shareholders aware of any potentially problematic incentives to which the director or nominee may be subject.

Beginning in 2013, a number of companies adopted bylaw provisions that *disqualify* individuals from serving as a director (rather than just requiring disclosure) if they received any compensation from a third party in connection with their candidacy or service as a director. These provisions proved controversial.

In January 2014, Institutional Shareholder Services (ISS) published a one-page policy statement that references this topic, without focusing in particular on the distinction between compensation for board service and compensation for candidacy.[3] The ISS policy provides that "the ability to elect directors is a fundamental shareholder right" and that "[b]ylaws that preclude shareholders from voting on otherwise qualified candidates unnecessarily infringe on this core franchise right." Under the policy, if a board unilaterally adopts such a bylaw, ISS "may, in such circumstances, recommend a vote against or withhold from director nominees for material failures of governance, stewardship, risk oversight, or fiduciary responsibilities." The policy statement also indicates that ISS will apply a case-by-case analysis both to any such bylaws that are put to a shareholder vote and to any director who has a third-party compensation arrangement.

More recently, the concerns over third-party compensation of directors and nominees have received renewed focus in the area of proxy access. Most companies specifically require disclosure of such arrangements in respect of proxy access candidates, and a meaningful minority prohibits individuals who have such compensation arrangements from being proxy access candidates.[4]

NEW NASDAQ RULE

Nasdaq has added a new provision to Rule 5250 that requires companies to disclose either on their website[5] or in their proxy or information statement for the election of directors (or in their annual report on Form 10-K or Form 20-F if they do not file a proxy or information statement), all agreements or arrangements between any director or nominee and any person other than the company that provide for

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3 ISS's policy on bylaws relating to third-party compensation of directors is available at http://www.issgovernance.com/file/files/directorqualificationcompensationbylaws.pdf. Similarly, in February 2014, Glass, Lewis & Co. adopted a policy of recommending against governance committee members if a board unilaterally adopts a bylaw disqualifying directors with third-party compensation arrangements. Glass Lewis's policy is available at http://www.glasslewis.com/restrictions-compensation-dissident-nominees-encounter-shareholder-opposition/.

4 For a discussion of these and other proxy access trends, see our publication, dated August 18, 2015, entitled "Proxy Access Bylaw Developments and Trends" available at https://www.sullcrom.com/siteFiles/Publications/SC_Publication_Proxy_Access_Bylaw_Developments_and_Trends.pdf.

5 The Rule does not specify where on the company's website the relevant disclosure should appear but does indicate that it can be satisfied by a link from the company's website to another website.

"compensation or other payment in connection with such person's candidacy or service as a director of the Company." The disclosure must include, at a minimum, the names of the parties and the material terms of the arrangement. Nasdaq's filing with the SEC states that the Rule is intended to be construed broadly and apply to "non-cash compensation and other payment obligations, such as health insurance premiums or indemnification, made in connection with a person's candidacy or service as a director."

This Rule change is founded on concerns similar to those that have spurred issuers to adopt bylaws addressing third-party compensation arrangements or to include the topic in director questionnaires. After noting that these third-party compensation arrangements "may not be publicly disclosed," Nasdaq's filing goes on to indicate that these arrangements could "lead to conflicts of interest among directors and call into question the directors' ability to satisfy their fiduciary duties" and that they may "tend to promote a focus on short-term results at the expense of long-term value creation."

Recognizing that some directors, particularly in the private equity context, are employees of large shareholders and are serving as directors of a portfolio company as part of that employment relationship, the Rule provides an exception for arrangements that existed prior to the candidacy, and that have been publicly disclosed, such as disclosure in the individual's proxy biography. If such an employee's compensation is materially increased in connection with the candidacy or directorship, then only the additional amount of compensation would need to be disclosed. In addition, no disclosure is necessary if the arrangement is simply to reimburse a candidate for expenses in connection with the candidacy, whether or not the arrangement has been publicly disclosed.

The listed company of course can only disclose arrangements that it knows about. For that reason, the Rule provides that a company will not be considered deficient under the Rule so long as it has undertaken reasonable efforts to identify all agreements or arrangements, including by asking each director or nominee in a manner designed to allow timely disclosure. If a company determines that an undisclosed arrangement exists that should have been reported, then it must promptly announce this in a Form 8-K or Form 6-K, where required by SEC rules, or in a press release.

The disclosure obligation under the Rule is on an annual basis until the earlier of the resignation of the director or one year following the termination of the agreement or arrangement, with no need for interim disclosure of changes in arrangements. Because it is an ongoing annual obligation, a one-time disclosure, for example pursuant to Item 5.02 of Form 8-K or in connection with a proxy solicitation, would meet the listed company's obligation under the Rule in the year it was disclosed but would not suffice for future annual periods.

In order to make the required disclosure by website, such disclosure must be publicly available through the website no later than the filing of the proxy or information statement (or Form 10-K or Form 20-F if the company is not obligated to file a proxy or information statement).

IMPLICATIONS

A Nasdaq-listed company should examine its most recent director questionnaire to ensure it elicits the required disclosures. If not, the company should promptly take appropriate steps, for example by circulating an e-mail confirmation to directors that no such arrangements or agreements exist, to elicit the relevant information. Even companies not listed on Nasdaq should consider taking similar steps to ensure that the board of directors has complete information with respect to director nominees.

It remains to be seen whether other national securities exchanges will follow the lead of Nasdaq. Commenters on the Rule raised concerns about the differing requirements that would apply to companies if only Nasdaq adopted the Rule.

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