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Exchanges Submit Proposals on Independence Standards for Compensation Committee Members and Advisors

Last week, the New York Stock Exchange (NYSE) and Nasdaq filed proposed revisions to their existing listing rules that incorporate the compensation committee member and advisor independence standards mandated by the Dodd-Frank Act and Rule 10C-1 adopted by the Securities and Exchange Commission (SEC) on June 20, 2012. The new provisions generally require that compensation committee members be “independent” and that committees have the authority to retain “independent” advisors as defined by each exchange. The proposed revisions of each exchange closely track the SEC rules, although Nasdaq took the opportunity to align its standards with existing audit committee rules in some areas and the NYSE rules in others.

Compensation Committee Independence

Both exchanges propose that a listed company’s board of directors affirmatively consider

- a) the source of compensation paid by the issuer to the member, including consulting, advisory or other compensatory fees, and
- b) any affiliation between the member and the company.

Each inquiry is intended to identify the extent to which the presence of one or both factors would impair the member’s judgment in reviewing and making recommendations about the company’s executive compensation. Nasdaq, however, went a step further by declaring that the receipt of any compensatory fees from the company – except those related to director services or past employment – is prohibited, thereby bringing the new standard in line with its

existing audit committee rules. The NYSE said that in addition to the new standards, it would continue to use its existing “bright line” independence standards to identify the types of relationships that would generally be material to a director’s independence for compensation committee service.

Both exchanges agreed that although a member’s affiliation with the company is a valid consideration, not all affiliate relationships would adversely affect a director’s ability to be independent from management. The NYSE explained that it “does not view the ownership of even a significant amount of stock, by itself, as a bar to an independence finding.” In fact, the NYSE noted 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 and Related Charters

Existing NYSE rules require issuers to maintain a chartered independent compensation committee. However, current Nasdaq rules provide an alternative means for a board to determine the compensation for the chief executive officer and other executive officers if the board does not have a compensation committee. Nasdaq’s proposed changes eliminate the alternative and require that a compensation committee comprised of at least two independent directors make these compensation decisions pursuant to a charter. Nasdaq also requires that companies review and reassess the adequacy of the compensation committee charter annually.

The proposed Nasdaq rules preserve an existing exception that permits a non-independent director to serve on the committee with two other independent members for up to two years under certain circumstances.

Compensation Advisor Independence

The rules proposed by both exchanges require that a compensation committee receive adequate funding and complete authority to retain and oversee the services of a compensation consultant, independent legal counsel or other advisors. Echoing the six independence factors identified by the SEC, both proposals specify that, before engaging an advisor, the compensation committee must consider the following factors:

- 1) other services provided to the listed company by the advisor,
- 2) the fees paid to the advisor in relation to the advisor’s total revenue,
- 3) the advisor’s conflict of interest policy and procedure,
- 4) any relationships between the advisor and members of the compensation committee,
- 5) whether the advisor owns stock in the listed company, and
- 6) any relationship between the advisor and an executive officer of the listed company.

In-house legal counsel is specifically exempt from the independence requirement, and although compensation committees are required to consider the enumerated factors, they are not prohibited from retaining the services of a non-independent advisor.

Cure Periods and Exemptions

Both exchanges include limited exemptions and opportunities for companies to cure deficiencies in compliance with the proposed rule changes. Specifically, Nasdaq proposes to apply the existing cure period for noncompliance with the requirement to have a majority independent board, which provides,

[I]f a Company fails to comply with the compensation committee composition requirements due to one vacancy, or one compensation committee member ceases to be independent due to circumstances beyond the member's reasonable control, the Company shall regain compliance by the earlier of the next annual shareholders meeting or one year from the occurrence of the event that caused the noncompliance.

The NYSE proposal adopts a similar standard but limits its use to circumstances in which the committee continues to have a majority of independent directors so as to ensure that decisions were made by independent directors.

Each exchange chose to recommend extending existing exemptions to the enhanced compensation standards proposed in the rule changes. However, smaller reporting companies, which are exempt under the SEC's Rule 10C-1, are not exempt under current Nasdaq rules. Therefore, Nasdaq's proposed rules explain that although smaller reporting companies are required to have a compensation committee comprised of independent directors as defined under Nasdaq's existing listing rules and adopt a written charter that specifies the compensation committee's responsibility and authority, they will not have to "adhere to the new requirements related to compensatory fees and affiliation ... or to incorporate into their formal written compensation committee charter ... the language regarding compensation advisors." The NYSE proposal contains similar changes with respect to its rules that apply to smaller reporting companies such that the companies "will effectively be subject to precisely the same requirements as is currently the case."

Effective Dates

The proposed changes are subject to final approval by the SEC, which are due no later than early next summer. The NYSE expects its changes to go into effect on July 1, 2013, and will give listing companies until the earlier of their first annual meeting after January 15, 2014, or October 31, 2014, to comply with the new standards.

The Nasdaq proposes that its rule changes related to compensation committee responsibilities and authority will be effective immediately and that companies must comply with the remaining provisions by the earlier of their second annual meeting held after the date that the amended listing rules are approved, or December 31, 2014.

What This Means to You

If your company is listed on either the NYSE or Nasdaq, you will need to prepare to comply with the new rules as soon as they are approved by the SEC. Because the proposed rule changes closely follow the standards contained in the SEC regulations, it is doubtful that the final versions will deviate significantly from the proposals. Here are some practical considerations for affected companies to consider and begin acting upon:

Identify which existing policies, processes and practices will be affected by the rule changes and begin to implement the new standards.

Those companies listed on Nasdaq that do not already have a compensation committee under charter must prepare to immediately comply with the following requirement that the committee have the specific responsibilities and authority necessary to

- a) retain compensation consultants, independent legal counsel and other compensation advisors,
- b) fund such advisors, and
- c) consider certain independence factors before selecting such advisors, other than in-house legal counsel.

Companies will have until the earlier of (a) their second annual meeting held after the date that Nasdaq's amended rules are approved or (b) December 31, 2014, to adopt a formal written charter granting these authorities and appointing a compensation committee.

Companies with existing compensation committee charters should review them for consistency with the new rules and prepare revisions to specifically incorporate the requirement that in affirmatively determining the independence of any director who will serve on the compensation committee (which should be reflected in the minutes), the board must consider the source of compensatory fees and whether the director is affiliated with the listed company. Note that in the case of a company listed on

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Nasdaq, the receipt of any compensatory fees except compensation related to director services or past employment is prohibited.

Finally, all companies should develop a process to evaluate the independence of outside advisors as contemplated by the proposed rules.

Contact Info

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