

## Exchanges Propose Listing Standards for Compensation Committees and Compensation Adviser Independence

On September 25, 2012, the New York Stock Exchange (“NYSE”) and Nasdaq filed with the SEC proposed amendments to their listing requirements that implement the compensation committee and adviser independence provisions of Securities Exchange Act Rule 10C-1 and Section 952 of Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank”). The proposed amendments, which do not stray far from the SEC rule, establish new standards for compensation committee member independence and the independence of compensation advisers. As discussed below, each proposal has a different effective date for the committee member requirements and the adviser independence requirements, and the two exchanges have slightly different effective dates as between one another.

### Compensation Committee Composition and Independence

Dodd-Frank and SEC Rule 10C-1 require the national securities exchanges to impose listing requirements that require each member of the listed company’s compensation committee to be independent. The exchanges may specify the factors that go into the independence determination, but at a minimum they must include consideration of the sources of a director’s compensation and whether the member is an affiliate of the listed company.

The NYSE proposal does not add any factors that boards must consider beyond the two identified in Dodd-Frank and reiterated by the SEC: namely, the source of a director’s compensation, including advisory or consulting fees paid by the listed company, and whether the director is an affiliate of the listed company. Because the board currently has to determine affirmatively that an independent director has no material relationships with the listed company, the NYSE has in effect layered in these two additional factors, plus any others that the board deems relevant, that will need to be considered in making that determination for a compensation committee member. There are no new “bright-line” rules that would disqualify a director.

Nasdaq took a slightly different approach. First, although not required to do so in this rulemaking, it will now require that executive compensation be determined by a committee of independent directors, eliminating the alternative that a majority of independent directors could set compensation for executives. For committee member independence, Nasdaq will prohibit a director who receives compensatory fees (other than fees for board service and fixed retirement payments) from serving on the compensation committee, rather than simply letting the board consider the receipt of fees in making its independence determination. For director affiliations, as with the NYSE’s proposal, Nasdaq simply includes affiliations as a factor that must be considered for compensation committee members when the board makes its independence determination. Nasdaq specifically noted that ownership of company stock itself would not preclude a finding of independence and stated 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,” a view also expressed by the NYSE. Like the NYSE, Nasdaq proposed no additional factors that must be considered.

### Compensation Committee Responsibilities, Authority and Charter

Dodd-Frank and SEC Rule 10C-1 requires the national securities exchanges to adopt rules that address the authority and responsibilities of a compensation committee. Specifically, compensation committees must have the authority to engage advisers including compensation consultants, independent legal counsel and other advisers, and compensation committees must be responsible for the appointment, compensation and oversight of the work of such advisers. The listing rules must also require companies to provide for

appropriate funding for the payment of reasonable compensation to advisers that the compensation committee retains. In addition, compensation committees must consider the following specific factors when selecting compensation consultants, legal counsel and other advisers: (i) other services the adviser provides to the company; (ii) the amount of fees the adviser receives from the company as a percentage of the adviser's total revenue; (iii) the adviser's policies and procedures on conflicts of interest; (iv) any business or personal relationship of the adviser with a member of the compensation committee; (v) any stock of the company owned by the adviser; and (vi) any business or personal relationship of the adviser or the person employing the adviser with an executive officer of the company.

Under the rules proposed by the NYSE and Nasdaq, a listed company would be required to set forth the foregoing authorities and responsibilities of the compensation committee, as well as the company's own responsibility to provide funding for the payment of the advisers hired by the compensation committee, in a written compensation committee charter. Nasdaq's proposed rule on this point would be effective *immediately*, which means that the adviser independence considerations would need to be conducted immediately.

The rules proposed by the NYSE and Nasdaq identified no additional factors related to independence from management that a compensation committee must consider when selecting compensation advisers. Nothing in either of the proposals requires compensation committees to engage independent advisers. They are merely required to consider any possible conflicts of interest before selecting an adviser. Consistent with the SEC rule, no determination would need to be made for in-house counsel who advises the compensation committee. The listing standards do not require any additional disclosure of these considerations, although companies currently must disclose how they address conflicts of interests of compensation consultants they engage.

Because Nasdaq is now requiring that there be a compensation committee, it had to address questions about its charter. It has proposed that a company certify that it has adopted a compensation committee charter and that it will review the charter annually. The charter must specify (i) the scope of the compensation committee's responsibilities, including membership requirements, (ii) the compensation committee's responsibility for determining, or recommending to the board, the compensation of the chief executive officer and all other executive officers, (iii) that the chief executive officer may not be present during voting or deliberation on his or her compensation, and (iv) the specific authority and responsibilities of the compensation committee discussed above. In addition, a compensation committee must have at least two members. Note, however, that the exception that allows a non-independent director, under exceptional and limited circumstances, to be a member of a compensation committee having at least three members remains generally unchanged.

## Cure Period

As required by Rule 10C-1, both the NYSE and Nasdaq proposals provide a "cure period" within which time a company not in compliance with the compensation committee composition requirements may regain compliance. The cure period under the NYSE proposal applies when a director ceases to be independent for reasons beyond his reasonable control, but only if the compensation committee continues to have a majority of independent directors. The non-compliant director may remain on the committee and the listed company would have until the earlier of the next annual shareholder's meeting or one year from the occurrence of the event that caused the director to be non-independent to regain compliance. Nasdaq's proposed rule applies to noncompliance due to a vacancy on the compensation committee in addition to a committee member's non-independence. The cure period under the Nasdaq rule is generally the same as the NYSE's, except that

companies relying on the cure provision would in all cases have at least 180 days to regain compliance. Both proposed rules require prompt notice of noncompliance.

### Smaller Reporting Companies and Phase-ins

Under the proposed rules, smaller reporting companies are generally exempt from the new compensation committee independence standards of both the NYSE and Nasdaq, as well as the requirements related to a compensation committee's consideration of an adviser's independence, but the other requirements would generally apply. In particular, smaller reporting companies listed on Nasdaq would not be exempt from the rule that requires a listed company to have a compensation committee consisting of two independent members and would be required to certify compliance with this rule and the compensation committee charter requirements.

A company that ceases to be a smaller reporting company under the rule proposed by the NYSE would have six months to comply with the compensation committee independence standards, but would become subject to the rules related to adviser selection immediately upon determining it was no longer a smaller reporting company (i.e., on the last day of the second fiscal quarter). Nasdaq proposed to apply the same phase-in schedule to a company ceasing to be a smaller reporting company that generally applies to a company with respect to audit committee listing requirements in conjunction with its initial public offering.

### Exemptions

Under Rule 10C-1, controlled companies, limited partnerships, companies in bankruptcy proceedings, open-ended management investment companies registered under the Investment Company Act of 1940 and certain foreign private issuers that make certain disclosures are exempt from these compensation committee member independence requirements. In addition, both the NYSE and Nasdaq proposed that entities currently exempt from existing compensation-related listing rules continue to be exempt from the revised rules relating to compensation committees. Phase-ins for controlled companies and foreign private issuers are consistent with the existing rules.

### Transition and Effective Dates

There will be a comment period, which is typically 21 days, after the SEC publishes the proposals in the Federal Register. If approved by the SEC, the NYSE's proposed changes to Section 303A of the Listed Company Manual would become operative on July 1, 2013, but companies would have until the earlier of their first annual meeting after January 15, 2014, or October 31, 2014, to comply with the new compensation committee independence standards. Under Nasdaq's proposal, companies would be required to comply with the new rules by the earlier of the second annual meeting held after the date the new rules are approved by the SEC or December 31, 2012, except that proposed rule on compensation committee responsibilities and authority, including the adviser independence determination, would be effective immediately, as noted above.

If you have questions about the proposals, please contact any member of Ropes & Gray's [securities & public companies](#) or [executive compensation](#) practice groups or your usual Ropes & Gray adviser.