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Securities Alert

NYSE and NASDAQ Propose Listing Standards for Compensation Committees and Compensation Advisers

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October 9, 2012

On September 25, 2012, the New York Stock Exchange and the NASDAQ Stock Market proposed rule changes to their respective listing standards affecting public company boards of directors, compensation committees and compensation advisers in response to recently adopted directives of the Securities and Exchange Commission.

This alert summarizes the new standards proposed by the NYSE and NASDAQ that are now pending SEC approval.

New York Stock Exchange Proposed Rules

The NYSE has proposed changes to Sections 303A.00, 303A.02(a) and 303A.05 of the NYSE's Listed Company Manual. If approved by the SEC, the revised NYSE rules would take effect on July 1, 2013.

Independence Test

Revised NYSE Section 303A.02 sets forth an independence test listed companies must use affirmatively to determine the independence of any director who will serve on a compensation committee. Once in effect, listed companies will have until the earlier of their first annual shareholder meeting after January 15, 2014, or October 31, 2014, to comply with the new director independence standards.

The rule states the board of directors must consider all factors specifically relevant to determining whether a director has a relationship to the listed company which is material to that director's ability to be independent from management in connection with the duties of a compensation committee member, including, but not limited to:

- the source of compensation of a member of the board including any consulting, advisory or other compensatory fee paid by the listed company to such director
- whether such director is affiliated with the listed company, a subsidiary of the listed company or an affiliate of a subsidiary of the listed company.

Revised NYSE Section 303A.00 provides that smaller reporting companies (as defined by the SEC) are exempt from complying with this rule. However, if a smaller reporting company ceases to be a smaller reporting company, it must comply with the rules within 6 months of determining it no longer qualifies as such.

Section 303A.00 currently provides that foreign private issuers are permitted to follow home country practice in lieu of compliance with the NYSE's compensation listing standards and the NYSE proposes to grant a general exemption from the new compliance committee requirements and allow foreign private issuers to follow home country practice.

This new section also provides a cure period for compensation committee independence non-compliance. Rule 303A.00 provides that if a member of the compensation committee ceases to be independent for reasons not within that member's control, the company must provide prompt notice to the NYSE, but if the majority of the members of the compensation committee continue to be independent, that member may remain a member of the compensation committee until the earlier of the next annual meeting or one year from the event that caused the member to be no longer independent.

The commentary to Rule 303A.02 explains that when considering the sources of a director's compensation, the board should consider whether the director receives compensation from any person or entity that would impair that member's judgment about the executive compensation for the company.

Compensation Committees

Revised NYSE Section 303A.05 provides that compensation committees of listed companies must have a written charter that grants the compensation committee the authority, and sole discretion, to retain or obtain the advice of a compensation consultant, independent legal counsel or other compensation adviser. The revised rules provide that the compensation committee is directly responsible for the appointment and oversight of any such consultant or adviser retained and that the listed company must provide for appropriate funding for the payment of any fees to such adviser. The rules clarify that the compensation committee is not required to implement any advice or recommendations of consultants and do not affect the ability or obligation of compensation committee members to exercise their own judgment on compensation matters.

The new rule also requires compensation committees (except for compensation committees of smaller reporting companies) to consider all factors relevant to any compensation consultant, legal counsel or other adviser's independence from management, including:

- The provision of other services to the listed company by the person that employs the compensation consultant, legal counsel or other adviser;
- 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;
- 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;
- Any business or personal relationship of the compensation consultant, legal counsel or other adviser with a member of the compensation committee;
- Any stock of the listed company owned by the compensation consultant, legal counsel or other adviser; and
- 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.

The SEC's rules implied that if, after considering the independence factors, the compensation committee determines that the compensation adviser is not independent, then the compensation committee may still retain such adviser so long as the committee has considered all the required factors. However, the new NYSE rules do not provide listed company committees with this option.

NASDAQ Stock Market Proposed Rules

NASDAQ has proposed changes to Sections 5605 and 5615 of its manual. If approved by the SEC, the revised NASDAQ rules would take effect when approved by the SEC.

If a listed company does not already have a compensation committee, the standards would apply to the independent directors who determine compensation until a committee is established. With respect to the compensation committee charter that will be required by revised rules described below, companies will have until the second annual shareholder meeting held after the date the rules are approved by the SEC, but no later than December 31, 2014 to implement such charter.

Independence Test

Revised NASDAQ Section 5605(d)(2) requires each company (including smaller reporting companies) to have a compensation committee of at least two members, each of whom meets the independent director standards already in place under Section 5605(a)(2) of the NASDAQ manual. No director on the compensation committee can accept directly or indirectly any consulting, advisory or other compensatory fee from the company or any subsidiary of the company (not including fees for service as a board or committee member or fixed compensation under a retirement plan for prior service with the company). In determining whether a director is eligible to serve on the compensation committee, a company's board must consider whether the director is affiliated with the company, a subsidiary of the company or an affiliate of a subsidiary of the company.

The commentary to the revised rules specifies that NASDAQ does not believe that stock ownership alone, or possession of a controlling interest in the company, precludes a board from finding a board member to be an appropriate member of the compensation committee.

The revised NASDAQ rules allow for non-independent compensation committee members in exceptional and limited circumstances. If the compensation committee is comprised of at least three members and one director does not meet the requirements discussed above, and that director is neither an executive officer, nor a family member of an executive officer, such director may be appointed to the compensation committee if the board, under exceptional and limited circumstances determines that such appointment would be required by the best interests of the company and its shareholders. If a company relies on this exception, such director may not serve for more than two years and the company must provide appropriate disclosure on the company's website or proxy statement for the next annual meeting.

The rules also provide for a cure period in the event of one vacancy or if a committee member is no longer independent due to an event beyond the member's reasonable control. Upon the occurrence of such an event, the company must provide immediate notice to NASDAQ and will have until the earlier of its next annual shareholder's meeting, or one year from the disqualifying event, to be in compliance with the independence standards. In the event the annual meeting is less than 180 days after the date of the disqualifying event, the company will have at least 180 days to be in compliance.

Compensation Committees

Revised Section 5605(d) of the NASDAQ manual provides that the compensation committee of a listed company must have a formal written charter complying with the NASDAQ rules and that such charter be reviewed annually for adequacy (smaller reporting companies may meet this requirement by adopting formal board resolutions addressing the below). Such charter or board resolutions 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 chief executive officer and all other executive officers of the company;
- That the chief executive officer may not be present during voting or deliberation on his or her compensation; and
- The authority and responsibility of the compensation committee to (i) retain compensation consultants, independent legal counsel and other compensation advisers, (ii) pay such advisers, and (iii) consider certain independence factors before selecting such advisers, other than in-house legal counsel (smaller reporting companies are not required to include these specific responsibilities and authorities in its charter or board resolutions).

Exemptions

Although smaller reporting companies are exempt from various aspects of the compensation committee standards, if a smaller reporting company ceases to be a smaller reporting company, it must provide a notice to NASDAQ within 30 days. Such notice must specify that the company has complied with the rules applicable to a smaller reporting company and has or will comply with the remaining rules on the schedule set forth in the manual in accordance with the phase in schedule set forth under the current NASDAQ rules.

The revised NASDAQ rules also state that a foreign private issuer following its home country practice in lieu of compliance with the NASDAQ rules must provide relevant disclosure in its annual report and explain why it does not have a compensation committee.

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