New Nasdaq Rule Requires Disclosure of Third Party Compensation of Directors and Nominees

Written by Paul Bork, Caroline P. Samp

September 7, 2016

Effective August 1, 2016, companies listed on Nasdaq are subject to a new rule requiring annual disclosure of the material terms of agreements or arrangements between directors or director nominees and third parties that relate to compensation or other payment in connection with that person's candidacy or service as a director.

This new Nasdaq Rule 5250(b)(3) is designed to enhance transparency by making investors aware of previously undisclosed compensation arrangements that could lead to director conflicts of interest and encourage directors to focus on short-term results rather than create long-term value for the company. Nasdaq companies should consider the scope, timing and manner of these new disclosure requirements, particularly when preparing for their next proxy season.

Scope of Compensation and Payments Required to be Disclosed

Nasdaq's commentary IM-5250-2 to the rule explicitly states that the terms "compensation" and "other payment" are "not limited to cash payments and are intended to be construed broadly." Nasdaq's proposal to the new rule cited health insurance premiums and indemnification as examples of disclosable non-cash compensation.

Companies have an affirmative responsibility to determine whether disclosures must be made. The new rule requires that a company undertake "reasonable efforts to identify all such agreements, including asking each director or nominee in a manner designed to allow timely disclosure." If a company's efforts are deficient under the rule, it must submit a plan to adopt, to Nasdaq's satisfaction, processes and procedures designed to identify and disclose relevant agreements or arrangements. Failure to follow these requirements may cause a company to be delisted.

Going forward, listed companies should consider whether their existing D&O questionnaires adequately capture information about disclosable third party compensation agreements and, if the questionnaires do not, they should be modified accordingly.

Timing and Manner of Disclosure

A company must make required third party compensation disclosures no later than the date on which it files or furnishes a definitive proxy or information statement in connection with its next shareholders' meeting at which directors are elected. Nasdaq specifically timed these disclosures to give shareholders enough time and information to allow them to make meaningful voting decisions at director elections. If a company does not file proxy or information statements, it must disclose third party compensation agreements no later than when it files its next Form 10 K. Alternatively, companies may make these disclosures via their websites, provided that the posting is made on or before the proxy or information statement (or the 10-K, if applicable) is filed and the information is continuously accessible.

Disclosure must be made annually for each director or nominee receiving third party compensation until either the director resigns from the board or one year after the compensation agreement or arrangement with the third party terminates. The company need not make additional disclosures when directors or nominees enter into new third party agreements or arrangements as long as the company complies with the annual disclosure requirements under the rule.

If a company discovers that an agreement or arrangement subject to disclosure was not reported in accordance with the rule, it must promptly disclose that agreement or arrangement by filing a Form 8-K or issuing a press release.

Disclosure Exceptions

In order to avoid duplicative disclosure otherwise required by SEC rules, companies need not make disclosures under Nasdaq Rule 5250(b)(3) if the arrangement or agreement relates to:

- Reimbursement of expenses in connection with a director nominee's candidacy;
- Compensation paid to employees or other agreements that predate the nominee's candidacy, as long as the company discloses the relationship between the nominee and the third party in a proxy or information statement, or annual report (although if the third party compensation materially increases in connection with a person's candidacy or service as a director, the difference between the new and previous compensation levels must be disclosed);
- Compensation already disclosed under SEC proxy rules that require certain disclosures in contested proxy solicitations; and
- Compensation already disclosed under Item 5.02(d) of Form 8-K (requiring disclosure of arrangements or understandings between new directors and third parties).

Companies relying on these exceptions, however, are still subject to the requirements of the new rule to make disclosures annually.

Possible Future Effect of Third Party Compensation on Director Independence

Nasdaq noted in its Rule 5250(b)(3) proposal that it is considering proposing additional rules relating to directors and candidates who receive third party payments, such as preventing directors or candidates who receive third party payments for their board candidacy or service from qualifying as independent directors or disqualifying them from serving on the board altogether. Nasdaq clarified that any such proposal would be the subject of a separate rulemaking, but also highlighted its definition of "independent director," which suggests that third party compensation arrangements may affect director independence.

RELATED PRACTICES

- Capital Markets
- Business Counseling
- Public Companies
