Nasdaq Proposes New Compensation Committee Listing Standards

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Standards implement Dodd-Frank Act and require formal committee charter

On September 25, 2012, the Nasdaq Stock Market issued proposed listing standards regarding compensation committees and their advisers, as called for by new SEC Rule 10C-1 under the Securities Exchange Act of 1934, which in turn was mandated by the Dodd-Frank Act.

In addition to the items required by the SEC rule, Nasdaq has proposed amending its listing standards to require listed companies to establish a standing compensation committee and to have a formal written charter addressing the committee's responsibilities and authority.

Committee Composition. Nasdaq will now require listed companies to establish a standing compensation committee consisting of at least two members, all of whom are independent. Previously, it had permitted compensation decisions to be made by vote of a majority of the listed company's independent directors.

Committee Independence. Nasdaq proposes to retain its current general independence standards for directors, which include certain bright line tests as well as requiring that the Board of Directors make an affirmative determination that an independent director has no relationship that, in the opinion of the Board, would interfere with the exercise of independent judgment in carrying out the responsibilities of a director. In addition, in response to Rule 10C-1, Nasdaq is proposing to add a requirement that compensation committee members cannot accept, directly or indirectly, <u>any</u> consulting or other compensatory fees from the listed company or its subsidiaries, other than for Board service (and retirement plan or deferred compensation payments for prior service to the company which is not contingent on continued service). This is the same standard regarding compensatory payments that applies to audit committee members, and does not include a look-back period. (The general independence standards for directors permit a director to earn up to $120,000 in compensation from the company without causing loss of independence, with a three-year look-back period.)

Unlike the standard for audit committees, the Nasdaq proposal does not preclude affiliates of the listed company from serving on the compensation committee. Instead, the Board must specifically consider whether a proposed committee member is an affiliate of (i) the listed company, (ii) a subsidiary of the company, or (iii) an affiliate of a subsidiary of the company, and if so, must determine whether such affiliation would impair the director's judgment as a member of the compensation committee. The Nasdaq commentary expressly states that it may be appropriate for certain affiliates, such as representatives of significant stockholders, to serve on a compensation committee. This standard also does not include a look-back period.

Nasdaq would also retain, with minor changes, its existing "exceptional and limited circumstances" exception from committee independence requirements and cure period provisions and apply them to compensation committees.

Committee Charter. In a departure from its current rules, Nasdaq is proposing to require compensation committees to adopt a formal written charter and to reassess its adequacy on an annual basis. The charter must specify:

- The scope of the committee's responsibilities and how it carries them out, including its structure, processes, and membership requirements;
- The committee's responsibility for determining, or recommending to the Board for its determination, the compensation of the chief executive officer and all other executive officers of the company;
- That the CEO may not be present during the committee's deliberations or voting on his or her compensation;
- The specific committee responsibilities and authority required by SEC Rule 10C-1, including the responsibility to consider specified independence factors before selecting consultants, legal counsel and other advisers.

Responsibilities and Authority Required by Rule 10C-1. The Nasdaq proposed listing standards do not restate the requirements of Rule 10C-1, but merely incorporate them by reference. These requirements are as follows:

- The compensation committee must have the ability, in its sole discretion, to retain or obtain the advice of a compensation consultant, independent legal counsel, or other adviser (collectively, "compensation advisers").
- The compensation committee must be directly responsible for the appointment, compensation, and oversight of the work of any compensation adviser that it retains.
- The listed company must provide adequate funding, as determined by the compensation committee, for payment of reasonable compensation to compensation advisers retained by the committee.
- Before selecting, or obtaining advice from, a compensation adviser (other than in-house legal counsel), the committee must consider the following independence factors:
    - The provision of other services to the listed company by the person that employs the compensation adviser (the "consulting entity").
    - The amount of fees received from the listed company by the consulting entity as a percentage of its total revenue.
    - The policies and procedures of the consulting entity that are designed to prevent conflicts of interest.
    - Any business or personal relationship of the individual compensation adviser

with a member of the compensation committee.

– Any stock of the listed company owned by the individual compensation adviser and their immediate families.

– Any business or personal relationship of the individual compensation adviser or the consulting entity with an executive officer of the listed company.

Although the SEC rule authorized the stock exchanges to expand the list of independence factors that a compensation committee must consider, Nasdaq concluded that the factors identified in the SEC rule were sufficient. The Nasdaq release reiterated the statement in the SEC release adopting Rule 10C-1 that although a compensation committee is required to consider the independence of any compensation adviser before selecting that adviser, there is no requirement that the adviser selected be independent.

Exemptions from Listing Standards. Companies currently exempt from Nasdaq's compensation-related listing standards would continue to be exempt from the revised standards. These include "controlled companies," defined as companies of which more than 50% of the voting power for the election of directors is held by an individual, group or another company. Foreign private issuers are permitted to follow their home country practices instead of the Nasdaq requirements if they publicly disclose (in their annual report filed with the SEC or, if none is required, on their website) the listing standards they do not adhere to and the home country practices followed instead. In addition, as required by Rule 10C-1, Nasdaq will require a foreign private issuer that does not have an independent compensation committee to disclose its reasons for not having such a committee.

Companies that subsequently become subject to the listing standards, for example upon an IPO or on emergence from bankruptcy, would be subject to the existing phase-in schedules for committee member independence. However, such companies would be subject to immediate compliance with the committee charter and committee responsibilities requirements.

Smaller Reporting Companies. Smaller reporting companies that are listed on Nasdaq are currently subject to the compensation-related listing standards. Nasdaq is proposing that they be subject to the new requirements to establish a compensation committee and that they specify the committee's responsibilities and authority in writing, but this may be in the form of a Board resolution rather than a formal charter, and it need not be reviewed annually. However, consistent with SEC Rule 10C-1, Nasdaq is proposing to exempt smaller reporting companies from the new requirements added by that rule with respect to the committee's authority to retain and compensate advisers and its responsibility to consider the independence of any compensation adviser that it retains.

Effective Dates. Nasdaq is proposing that the provisions of its listing standards implementing the portion of SEC Rule 10C-1 dealing with committee authority and responsibility, including committee consideration of the independence of compensation advisers, be effective immediately upon adoption of the final listing standard. The enhanced committee independence criteria and the committee charter requirements are not effective until the earlier of (i) the second annual meeting held after adoption of the final listing standards, or (ii) December 31, 2014. However, companies may wish to adopt or amend committee charters to reflect at least the new committee authority and responsibility provisions at the same time those substantive provisions become effective. Nasdaq will require companies to certify their compliance with the new listing standards within 30 days after the applicable standard becomes effective.

For more information about the stock exchange listing standards relating to compensation committees and consultants, or Hughes Hubbard's executive compensation and corporate governance practices, please contact any of the following attorneys:

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Executive Compensation Practice and
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October 2012

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