

LEGAL UPDATE

October 2012 By: Michael T. Campoli

NYSE AND NASDAQ PROPOSE ENHANCED COMPENSATION COMMITTEE LISTING STANDARDS

On September 25, 2012, the New York Stock Exchange (the “NYSE”) and the Nasdaq Stock Market (“Nasdaq”) proposed amendments to their corporate governance listing standards to implement the requirements of Rule 10C-1 under the Securities Exchange Act of 1934 (the “Exchange Act”). Rule 10C-1 directs the national securities exchanges to adopt listing rules effectuating the requirements mandated by Section 952 of the Dodd-Frank Wall Street Reform and Consumer Protection Act regarding the authority and responsibilities of compensation committees and the independence of their members. The U.S. Securities and Exchange Commission (the “SEC”) adopted Rule 10C-1, which was required by Section 10C of the Exchange Act, on June 20, 2012.

The proposed rules are subject to public comment and approval by the SEC.

NYSE PROPOSED RULES

Composition of Compensation Committee

The NYSE’s current listing standards require that all members of an issuer’s compensation committee be “independent.” A director will qualify as “independent” if he or she does not have a relationship with the issuer that violates any one of the “bright line” tests that specifically exclude such director from being considered independent, and the board determines, after a review of all relevant facts and circumstances, that the director does not have a material relationship with the issuer.

The NYSE is proposing to make independence standards more stringent for compensation committee members by requiring that the board also consider all factors specifically relevant to determining whether any such director has a relationship to the issuer that is material to his or

her ability to be independent from management in connection with the duties of a compensation committee member. This would include a consideration of: (i) whether the director receives compensation from any person or entity that would impair his or her ability to make independent judgments about the issuer’s executive compensation; and (ii) whether the affiliate relationship places the director under the direct or indirect control of the issuer or its senior management, or creates a direct relationship between the director and members of senior management, in each case of a nature that would impair his or her ability to make independent judgments about executive compensation. These independence factors substantially repeat those set forth in Rule 10C-1 of the Exchange Act.

The NYSE noted that the ownership by a director or any of his or her affiliates of a significant amount of the issuer’s securities would not, in and of itself, preclude a finding of independence.

If a compensation committee member ceases to be independent for reasons outside the member’s reasonable control, that person, with notice by the issuer to the NYSE, may remain a compensation committee member until the earlier of the next annual meeting or one year from the occurrence of the event that caused the member to be no longer independent, so long as the committee continues to have a majority of independent directors.

Authority and Responsibilities

Rules 10C-1(b)(2) and (3) of the Exchange Act require the national securities exchanges to adopt rules that mandate that compensation committees have broad authority with respect to compensation consultants, legal counsel and other advisers (collectively, “compensation advisers”) that are

engaged to assist compensation committees in the performance of their duties. Specifically, compensation committees must have the power to retain the advice of compensation advisers and to appoint, compensate and oversee such advisers. In addition, issuers must provide for appropriate funding to compensate compensation advisers. The NYSE is proposing to adopt these requirements, which are in significant part already included in the NYSE's existing compensation committee listing standards, as they appear in Rule 10C-1, and to remove the comparable requirements set forth in existing NYSE rules.

Before engaging any compensation adviser, NYSE-listed issuers would be required to consider the factors set forth in Rule 10C-1(b)(4) of the Exchange Act¹, as well as any other factors that would be relevant to the adviser's independence from management. The NYSE did not add any additional factors to be considered beyond those set forth in the SEC rules, expressly stating its belief that such factors are "very comprehensive."

Exemptions

The NYSE is proposing a general exemption from the applicability of the new compensation committee rules for all of the categories of issuers that are currently exempt from the NYSE's existing compensation committee requirements, including controlled companies, limited partnerships, companies in bankruptcy, funds registered under the Investment Company Act of 1940, passive business organizations in the form of trusts, derivatives and special purpose securities, and issuers whose only listed equity security is a preferred stock. Foreign private issuers that follow home country practices would also be granted a general exemption under the proposal.

Smaller Reporting Companies

¹ These factors are: (i) the provision of other services to the listed company by the person that employs the compensation adviser; (ii) the amount of fees received from the listed company by the person that employs the compensation adviser, as a percentage of the total revenue of the person that employs the compensation adviser; (iii) the policies and procedures of the person that employs the compensation adviser that are designed to prevent conflicts of interest; (iv) any business or personal relationship of the compensation adviser with a member of the compensation committee; (v) any stock of the listed company owned by the compensation adviser; and (vi) any business or personal relationship of the compensation adviser or the person employing the adviser with an executive officer of the listed company.

Smaller reporting companies would be exempt from the proposed committee member and compensation adviser independence requirements. However, they would be subject to the other requirements regarding the authority and responsibility of compensation committees.

Effective Dates

NYSE-listed companies would have until the earlier of their first annual meeting after January 15, 2014, or October 31, 2014, to comply with the new independence standards for compensation committee members. Such companies would become subject to the remainder of the proposed requirements on July 1, 2013.

Phase-In Schedules

In general, the existing transition periods available to newly-listed companies – such as companies listing in connection with an initial public offering, spin-off or carve-out, companies listing upon emergence from bankruptcy, companies previously registered under Section 12(g) of the Exchange Act, companies previously registered under Section 12(b) of the Exchange Act to the extent the national securities exchange on which they were listed did not have the same requirement, and companies that cease to qualify as a controlled company or a foreign private issuer – would continue to apply with respect to the proposed compensation committee independence requirements.

NASDAQ PROPOSED RULES

Establishment of Compensation Committee

For the first time, Nasdaq is proposing to require all issuers to have a standing compensation committee comprised of at least two independent directors. Currently, issuers are permitted to have a majority of the independent directors then serving on the board make executive compensation decisions.

Composition of Compensation Committee

Members serving on the compensation committee would continue to be required to be "independent." Under current rules, a director will qualify as "independent" if he or she does not have a relationship with the issuer that violates any of the "bright line" tests that specifically exclude such director from being considered independent, and the board determines that he or she does not have a

relationship that would interfere with the exercise of independent judgment in carrying out the responsibilities of a director.

In addition, Nasdaq is proposing to require that compensation committee members also cannot accept, directly or indirectly, any consulting, advisory or other compensatory fee from an issuer, with limited exceptions.² This is the same standard currently applicable to audit committee members. Furthermore, although Nasdaq is not proposing to preclude affiliates of the issuer from serving on the compensation committee, the proposal requires boards to consider any affiliation between the director and the issuer when determining whether such affiliation would impair the director's judgment as a member of the compensation committee.

Similar to the NYSE proposal, a director would not be precluded from being found independent solely because the director or any of his or her affiliates are shareholders who own more than some specified percentage of the issuer's securities. There is no "look-back" period for either the compensatory fee or the affiliation requirements, which only begin with the member's term of service on the compensation committee.

Nasdaq would retain its existing exception that permits certain non-independent directors to serve for up to two years on a compensation committee consisting of at least three members under exceptional circumstances.

If a compensation committee member ceases to be independent due to circumstances beyond such member's reasonable control, the issuer will have until the earlier of: (i) the next annual shareholders meeting following the occurrence of the event that caused the noncompliance (or at least 180 days if the meeting occurs earlier); and (ii) one year from the occurrence of such event, to regain compliance with the listing requirements.

Charter; Authority and Responsibilities

Nasdaq proposes to require each issuer to adopt a written charter for its compensation committee. The

² The exceptions include payments for board service fees and fixed compensatory amounts received pursuant to a retirement plan for prior service to the issuer.

compensation committee must review and reassess the adequacy of the charter on an annual basis.

The charter must specify: (i) the scope of the compensation committee's responsibilities, and how it carries out those responsibilities; (ii) the committee's responsibility for determining, or recommending to the board for the determination of, the compensation of the issuer's executive officers; and (iii) that the CEO of the issuer may not be present during voting and deliberations on his or her compensation.

In addition, the charter must set forth the specific compensation committee responsibilities and authority regarding the retention of compensation advisers, the funding of such advisers, and the responsibility to consider certain independence factors before selecting such advisers, as set forth in Rule 10C-1 under the Exchange Act. The independence factors that Nasdaq is proposing that issuers take into consideration when engaging a compensation adviser are the same as those proposed by the NYSE (which, in turn, are the same factors contained in Rule 10C-1(b)(4) of the Exchange Act).

Consequently, once the SEC approves the rules proposed by the NYSE and Nasdaq, the compensation committees of both NYSE and Nasdaq issuers would possess substantially identical responsibilities and authority with respect to retention, funding and evaluation of compensation advisers.³

Exemptions

Issuers that are currently exempt from Nasdaq's compensation-related listing rules, including asset-backed issuers and other passive issuers, cooperatives, limited partnerships, management investment companies and controlled companies, would be exempt from the revised listing rules relating to compensation committees. Foreign private issuers would be permitted to continue to follow their home country practice in lieu of Nasdaq's revised listing rules if they disclose in their annual reports each requirement that they do not follow, describe the home country practice that

³ See the discussion of the authority and responsibilities of the compensation committees of NYSE-listed issuers above in this Legal Update under the heading "NYSE Proposed Rules – Authority of Compensation Committee".

they follow in lieu of such requirements and, with respect to foreign private issuers that follow their home country practice in lieu of having an independent compensation committee, disclose the reasons why they do not have such a committee.⁴

Smaller Reporting Companies

Smaller reporting companies would be required to establish compensation committees comprised of at least two directors who meet Nasdaq's current definition of independence. However, such companies would not have to adhere to the new requirements relating to compensatory fees and affiliation.

In addition, although smaller reporting companies would have to adopt a compensation committee charter that specifies the same content as other companies,⁵ this charter would not have to include the specific responsibilities relating to the authority to retain compensation advisers, the authority to fund such advisers, and the responsibility to make an assessment of compensation advisers. The charter need not be reviewed and reassessed annually.

Effective Dates

The proposed rules relating to compensation committee responsibilities and authority, including the requirement to assess the independence of compensation advisers, would be effective immediately upon SEC approval. Issuers would have until the earlier of their second annual meeting held after the date of approval of the amended listing standards, or December 31, 2014, to comply with the enhanced committee independence criteria and the committee charter requirements.

Phase-In Schedules

Nasdaq's existing phase-in schedules for complying with compensation committee composition standards applicable to newly-listed companies, such as companies listing in connection with an IPO or emerging from bankruptcy, would remain generally unchanged. However, such issuers would

⁴ Alternatively, a foreign private issuer that is not required to file its annual report with the SEC on Form 20-F may make the required disclosure on its website.

⁵ Unlike larger issuers, smaller reporting companies may include this content in a board resolution, rather than a compensation committee charter.

be subject to immediate compliance with the committee charter and committee authority and responsibilities requirements.

ACTIONS TO TAKE

In anticipation of the proposed listing standards becoming effective, NYSE and Nasdaq-listed issuers should consult with legal counsel in connection with taking the following actions:

- analyzing the composition of their compensation committees to assess whether all members will meet the enhanced independence requirements, and considering whether any members should be replaced;
- reviewing their compensation committee charters and considering any changes that will be necessary to comply with the proposed listing standards;
- evaluating their existing policies and procedures regarding the retention, compensation and evaluation of compensation advisers to determine whether they are consistent with the proposed listing standards; and
- reviewing and revising Director and Officer's Questionnaires to reflect the new independence standards.

In addition, Nasdaq issuers that do not have a compensation committee should prepare to establish one, and Nasdaq issuers that do not have a compensation committee charter should begin the process of drafting and adopting one.

The foregoing is merely a discussion of the NYSE and NASDAQ's proposed rules regarding the composition, authority and responsibilities of the compensation committees of listed issuers. If you would like to learn more about this topic or how Pryor Cashman LLP can serve your legal needs, please contact Michael T. Campoli at 212-326-0468 or mcampoli@pryorcashman.com.

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Michael Campoli devotes his practice to counseling public and private companies at all stages of development on a broad range of corporate matters, including securities law compliance, formation and governance, M&A, public and private equity and debt financings, and limited liability company and partnership counseling.

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- Henry Schein, Inc. in connection with the acquisition of various private companies in the medical equipment and software industries
- Cowen and Company, LLC, Rodman & Renshaw, LLC and Global Hunter Securities, LLC in connection with various underwritten public offerings for domestic and foreign issuers
- Briad Restaurant Group in its prevailing tender offer for Main Street Restaurant Group, Inc., the largest T.G.I. Friday's franchisee
- The Kushner Companies in connection with its acquisition of the office building located at 666 Fifth Avenue, New York, New York
- A private telecommunications company in connection with the issuance of secured notes to the Rural Utilities Service of the U.S. Department of Agriculture and the concurrent placement of preferred stock to venture capital investors