

securities lawflash

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NASDAQ Amends Compensation Committee Independence Rules

Amendment eliminates prohibition on the receipt of compensatory fees and aligns NASDAQ listing rules with NYSE standards.

On December 11, 2013, NASDAQ Stock Market LLC amended its listing standards relating to the independence of compensation committee members to remove the prohibition of the receipt of compensatory fees by compensation committee members.¹ The amended rules would require the board of directors of NASDAQ-listed companies to only consider the receipt of compensatory fees as a factor in determining director independence for purposes of serving on the compensation committee. The amendment also provides additional guidance on the amended listing standards, including the application of the second part of the independence test relating to the director's affiliate relationship with the company. As a result of this amendment, NASDAQ's compensation committee independence rules are now aligned with the standards adopted by the New York Stock Exchange (NYSE) and other major exchanges.

Under the existing implementation timeline, NASDAQ-listed companies must comply with the independence requirements of compensation committee members by the earlier of (a) the first annual meeting after January 15, 2014 or (b) October 31, 2014. This amendment should make it easier for companies to comply with such requirements. In addition, NASDAQ-listed companies are required to provide NASDAQ with a certification to confirm their compliance with the compensation committee independence and charter requirements no later than 30 calendar days from this deadline.

Background

In January 2013, the Securities and Exchange Commission (SEC) approved final rules implementing the listing standards of NASDAQ and NYSE relating to the independence of compensation committee members as directed by the Dodd-Frank Wall Street Reform and Consumer Protection Act, which added section 10C to the Securities and Exchange Act of 1934, as amended (Exchange Act).² Section 10C-1 required the exchanges to adopt rules mandating companies to consider the following two factors relating to the independence of compensation committee members prior to listing:

- Any compensation received by the director from any person or entity (including any consulting, advisory, or other compensatory fee paid by the company to such director).
- The director's affiliate relationship with the company, its subsidiary, or an affiliate of a subsidiary of the company.

While section 10C-1 only required the consideration of compensatory fees when determining the independence of compensation committee membership, NASDAQ adopted a more stringent standard, under which the receipt by a

1. View the amended rules at <http://nasdaq.cchwallstreet.com/NASDAQ/pdf/nasdaq-filings/2013/SR-NASDAQ-2013-147.pdf>.

2. For more information on the NYSE and NASDAQ listing standards approved by the SEC, see our February 5, 2013 LawFlash, "SEC Approves Final NYSE and NASDAQ Compensation Committee Rules," available at http://www.morganlewis.com/pubs/Securities_LF_NYSE-NASDAQCompensationCommitteeRules_05feb13.

director of any fees from the company, even a *de minimis* amount, would bar service on the compensation committee. This approach is similar to the audit committee independence requirements under the Sarbanes-Oxley Act, which also imposes a mandatory prohibition on the receipt of compensatory fees. Following the adoption of final rules, NASDAQ received significant negative feedback from listed companies complaining about the higher standard that made it more difficult to recruit qualified directors. In response to this feedback and confronted with the prospect of companies migrating to NYSE and other exchanges that have not deviated from the section 10C-1 requirements, NASDAQ decided to amend the listing rules to follow more closely the mandate of section 10C-1.

Summary of Amended Rules

The amended rules replace the prohibition on the receipt of compensatory fees by compensation committee members with the requirement that, in determining the independence of those members, the board must consider the source of compensation of the director, including any consulting, advisory, or compensatory fees paid by the company to the director. The amendment also clarifies 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 the director's ability to make independent judgments about the company's executive compensation."

The amendment also eliminated the two previous exceptions of compensatory fees that could be excluded from the analysis: (i) fees received as a member of the board or a committee of the board and (ii) the receipt of fixed amounts of compensation under a retirement plan for prior service with the company. As a result, the board must now consider all of these fees, together with all other sources of compensation received by the director, to determine whether the director is independent.

In addition, the amendment added language to clarify the general approach to analyzing the independence of compensation committee members. Specifically, NASDAQ would require the board to consider "all factors specifically relevant to determining whether a director has a relationship to the company which is material to that director's ability to be independent from management in connection with the duties of a compensation committee member." This language is consistent with the current NYSE standard. It is important to note that the amendment does not affect NASDAQ's existing listing standards that prohibit an independent director from receiving compensation from the company in excess of \$120,000 during any 12-month period within the prior three years, except fees for service on the board or committee.

The amendment also provides interpretive guidance relating to the second part of the section 10C-1 test with respect to affiliate relationships. Under the amended rules, when considering any affiliate relationship a director has with the company, a subsidiary, or an affiliate of a subsidiary, the board should consider whether such relationship places the director under the direct or indirect control of the company or its senior management, or creates a direct relationship between the director and members of senior management, that would impair the director's ability to make independent judgments about executive compensation.

Practical Considerations

As a result of this amendment, NASDAQ-listed companies should reexamine the composition of their compensation committees to ensure compliance with amended listing rules prior to the implementation deadline. NASDAQ-listed companies should also review their committee charters, directors' and officers' (D&O) questionnaires, and corporate governance guidelines or policies to determine whether any changes are required. For example, companies may need to update their D&O questionnaires for the 2014 proxy season to include additional questions soliciting information on the sources of compensation of directors and, if applicable, remove the exemption of fixed amounts of compensation under a retirement plan from existing questions relating to fees received by directors.

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