

New NYSE and NASDAQ Rules Require Review of Compensation Committee Charters

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On June 20, 2012, the SEC, acting under a mandate of the Dodd-Frank Act, adopted rules directing the national securities exchanges to prohibit the listing of any equity security of an issuer that is not in compliance with specified compensation committee and compensation adviser requirements.

The NYSE and NASDAQ have now proposed such rules. These rules include new requirements for compensation committee charters, which should prompt NYSE and NASDAQ companies to review their charters so as bring them into compliance. The rules are subject to SEC approval, which is likely before the next round of calendar year company annual meetings.

NYSE

Current NYSE rule 303A.05(b) imposes a requirement that the compensation committee have a written charter that addresses the committee's purpose and responsibilities, and provides for an annual performance evaluation of the committee. In the current NYSE "commentary" to rule 303.05, companies are advised that the charter "should also address" committee member qualifications. Most NYSE companies have followed this recommendation and have included such provisions in the committee charter.

In addition, the commentary states that if a compensation consultant is to assist in the evaluation of compensation, the charter should give the committee sole authority to retain and terminate the consulting firm, including sole authority to approve the firm's fees and other retention terms. Most NYSE companies have included these types of provisions in the committee charter.

The NYSE now proposes to amend this rule and the associated commentary so as to change the requirements for the compensation committee charter. These amendments, subject to SEC approval, will be effective July 1, 2013. As a result, NYSE companies should schedule a review of their current compensation committee charters so that any changes necessary to comply with the new rules can be made by that date.

Use of advisers. The amendments delete the portion of the commentary currently recommending that the charter include provisions giving the committee the authority to retain compensation advisers. Instead, a new paragraph (iii) is added to rule 303A.05, now mandating that the charter address "the rights and responsibilities of the compensation committee set forth in Section 303A.05(c)."

New paragraph (c) of rule 303A.05 sets forth the rights and responsibilities of the committee that the charter is now required to "address." This paragraph provides:

- (c)(i) The compensation committee may, in its sole discretion, retain or obtain the advice of a compensation consultant, independent legal counsel or other adviser.
- (ii) The compensation committee shall be directly responsible for the appointment, compensation and oversight of the work of any compensation consultant, independent legal counsel or other adviser retained by the compensation committee.
- (iii) The listed company must provide for appropriate funding, as determined by the compensation committee, for payment of reasonable compensation to a compensation consultant, independent legal counsel or any other adviser retained by the compensation committee.
- (iv) The compensation committee may select a compensation consultant, legal counsel or other adviser to the compensation committee only after taking into consideration all factors relevant to that person's independence from management, including the following:
 - (A) The provision of other services to the listed company by the person that employs the compensation consultant, legal counsel or other adviser;
 - (B) 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;
 - (C) 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;
 - (D) Any business or personal relationship of the compensation consultant, legal counsel or other adviser with a member of the compensation committee;
 - (E) Any stock of the listed company owned by the compensation consultant, legal counsel or other adviser; and
 - (F) 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.

A commentary is also added to paragraph (c) stating that the independence assessment outlined in paragraph (iv) is required for any adviser that "provides advice to" the compensation committee, other than in-house legal counsel.

In reviewing an existing charter, an NYSE company may be able to determine that paragraphs (i) through (iii) above are currently satisfactorily addressed in the charter, through provisions that were included pursuant to the current (now to be deleted) recommendation in the commentary. A company may determine, however, to substitute the new language on this topic from paragraphs (i) through (iii) in place of prior charter language so as to avoid any compliance issue.

A company will likely find that its current charter does not address the responsibilities of the committee to assess the independence of its advisors; the new rules require that the charter do so. As a result, a charter provision stating these responsibilities may need to be added.

Independence of compensation committee members. The new rules leave unchanged the prior statement in the commentary recommending that the charter address committee qualifications, and many charters currently do. However, the new rules change the provisions specifying the qualifications for compensation committee members, which may necessitate a change in the way that such qualifications are described in the charter.

Previously, rule 303A.05(a) required only that the compensation committee be composed entirely of “independent” directors. This utilizes the definition of “independence” in 303A.02(a) and incorporates the factors that preclude a finding of independence under 303A.02(b). This provision remains unchanged, but another element for independence of compensation committee members is now added. New 303A.05(a) provides that compensation committee members must also satisfy the additional independence requirements specific to compensation committee membership set forth in new 303A.02(a)(ii), which provides:

(ii) In addition, in affirmatively determining the independence of any director who will serve on the compensation committee of the listed company’s board of directors, 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:

(A) the source of compensation of such director, including any consulting, advisory or other compensatory fee paid by the listed company to such director; and

(B) 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.

New language is added to the commentary to this section indicating that the board should consider whether the director receives compensation from any person or entity that would impair his ability to make independent judgments about the listed company’s executive compensation.

Existing charters addressing the qualifications of compensation committee members would not refer to this new independence element, and therefore a revision may be needed. The new independence element is not effective until the earlier of the second annual meeting after SEC approval of the new rules, or October 31, 2014. Accordingly, the charter would not be required to be amended to reflect this element until such date. Alternatively, the charter could be amended earlier to reflect an earlier adoption of this element or could specify a deferred effective date for this provision.

NASDAQ

Prior to the new proposed rules, NASDAQ companies were not required to have compensation committee charters. However, many do have such charters as a matter of good governance practice; often these have been modeled after the NYSE requirements.

The new rules now require a NASDAQ company to have a compensation committee charter. The charter is required to be in place by the earlier of the second annual shareholders' meeting after the effective date of the new rules (which are likely to be effective this year), or December 31, 2014. Accordingly, NASDAQ companies should schedule adoption of a charter for the compensation committee, if they do not already have one, by such deadline. (Certain of the matters embodied in the charter, such as the committee having the ability to retain and pay for consultants, and the obligation of the committee to make certain independence assessments before selecting consultants, will be effective immediately upon approval of the new rules by the SEC; however, the requirement to embody these in the charter will apply later.)

New rule 5605(d) provides both that the company must have a compensation committee charter and that the charter must be reviewed and its adequacy reassessed annually. The charter must specify the scope of the committee's responsibilities and how it carries out those responsibilities, and must specify membership requirements. The charter must specify that the chief executive officer may not be present during voting or deliberations on his or her compensation. In addition, the charter must state the specific compensation committee responsibilities and authority set forth in new rule 5605(d)(3).

Use of consultants. Rule 5605(d)(3) states that the compensation committee must have the specific compensation committee responsibilities and authority necessary to comply with 1934 Act Rule 10C-1(b)(2), (3) and (4)(i)-(iv) relating to the authority to retain compensation advisers and pay for them, and the responsibility to consider certain independence factors before selecting advisers, other than in-house legal counsel. (These are the same factors identified above for NYSE companies.)

For NASDAQ companies without a compensation committee charter, a charter will need to be developed to comply with these requirements. For companies that currently have a charter, it should be reviewed. Current charters will likely require some revision to reflect the new requirements, particularly the committee's responsibilities to consider specified independence factors before retaining advisers.

Independence of compensation committee members. The charter is required to specify the requirements for membership on the compensation committee. Current charters may specify such requirements, but will require revision because the membership requirements are altered under the new rules. Previously, compensation committee members were required only to meet NASDAQ's general independence requirements for directors, which have not changed.

The new rules add a requirement that a compensation committee member may not accept directly or indirectly any compensatory fee from the company or any subsidiary, other than fees received for board service or under specified retirement plans. In NASDAQ's submission of the proposed rule change for SEC approval, NASDAQ indicated its intention that this requirement



would make applicable to compensation committee members the same prohibition on direct or indirect acceptance of compensatory fees that currently applies to audit committee members. As such, the new rules would incorporate the guidance of 1934 Act Rule 10A-3(c)(8), which states that indirect acceptance of a compensatory fee includes acceptance by an entity in which the director is a partner and which provides accounting, consulting, legal, investment banking or financial advisory services to the issuer. Thus, for example, a director who is a partner in a law firm that provides services to the company will be ineligible to serve on the compensation committee. Also, under the new rules, the board must consider whether the director is an affiliate of the company and, if so, whether such affiliation would impair the director's judgment as a member of the compensation committee.

Existing charters for NASDAQ companies will likely require revision to reflect these new independence requirements. New charters will need to include them.

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