RADFORD ALERT

Nasdaq Releases Proposed Listing Standards to Implement New Independence Requirements Under SEC Rule 10C-1

At the end of June 2012, the Securities and Exchange Commission (SEC) released final rules under Section 952 of the Dodd-Frank Wall Street Reform Act pertaining to Compensation Committee and compensation adviser independence. The new standards include the adoption of Rule 10C-1 under the Securities and Exchange Act of 1934 (Rule 10C-1) and amendments to Item 407 of Regulation S-K (Item 407). Together, these standards will now govern the process by which Boards maintain the independence of Compensation Committees, manage potential conflicts of interest and assess the impartiality of key advisers, namely compensation consultants.

Following the publication of its new independence standards, the SEC required all US exchanges to file proposed listing requirements addressing the implementation of Rule 10C-1 by September 25, 2012. To this end, the following Radford Alert summarizes key elements of the proposed listing requirements recently announced by the Nasdaq Stock Market (Nasdaq). To read the complete Nasdaq rule proposal, click here.

For a refresher on the SEC's final independence standards published in June, we encourage clients to read the Radford Alert: Assessing the Impact of New SEC Compensation Committee Independence Standards.

Compensation Committee Independence and Structure

Nasdaq's newly proposed listing requirements pertaining to Compensation Committee independence are generally similar to those adopted by the SEC pursuant to Rule 10C-1. However, Nasdaq's rules are broader in scope and require companies to consider additional factors not originally enumerated by the SEC. The more expansive set of rules proposed by Nasdaq is in large part driven by existing Nasdaq rules, which listed companies are already expected to follow. Nasdaq's proposed listed requirements, as stated directly by the exchange, provide that:

> Companies must have a Compensation Committee consisting of at least two members, each of whom must be an Independent Director as defined under Nasdaq's current listing rules;

> Compensation Committee members must not accept directly or indirectly any consulting, advisory or other compensatory fee, other than for Board service, from a Company or any subsidiary thereof;

> In determining whether a Director is eligible to serve on a Compensation Committee, a Company's Board must consider

Board Action Items:

The first requirement proposed by Nasdaq is certainly worth highlighting, as it requires companies to have a formal Compensation Committee. In the past, a majority of the Board's independent Directors could function in lieu of a formal committee.

whether the Director is affiliated with the Company, a subsidiary of the Company or an affiliate of a subsidiary of the Company to determine whether such affiliation would impair the Director's judgment as a member of the Compensation Committee;

> Companies may continue to rely on Nasdaq's existing exception that allows certain non-Independent Directors to serve on a Compensation Committee under exceptional and limited circumstances;

> If a Company fails to comply with the Compensation Committee composition requirements in certain circumstances, it may rely on a cure period;

> Companies must adopt a formal, written Compensation Committee charter that must specify the Compensation Committee responsibilities and authority in Rule 10C-1 relating to the: (i) authority to retain compensation consultants, independent legal counsel and other compensation advisers; (ii) authority to fund such advisers; and (iii) responsibility to consider certain independence factors before selecting such advisers, other than in-house legal counsel;

Board Action Items:

Notably, Nasdaq's proposed rules require listed companies to adopt or amend existing Compensation Committee charters to specifically address the requirements of SEC Rule 10C-1, including items related to the retention of consultants.

> Companies must review and reassess the adequacy of the Compensation Committee charter on an annual basis;

> Nasdaq's existing exemptions from, and phase-in schedules for, the compensation-related listing rules remain generally unchanged; and

> Smaller Reporting Companies must have a Compensation Committee comprised of at least two Independent Directors and a formal written Compensation Committee charter or Board resolution that specifies the committee's responsibilities and authority, but such Companies are not required to adhere to the Compensation Committee eligibility requirements relating to compensatory fees and affiliation, or the requirements relating to compensation consultants, independent legal counsel and other compensation advisers that Nasdaq is proposing to adopt under Rule 10C-1.

As we allude to above, Nasdaq's new listing requirements work in concert with a number of existing Nasdaq rules—most notably Nasdaq Listing Rule 5605, which covers Director independence standards, Compensation Committee charter development and Compensation Committee composition, among other items. For a more detailed discussion on the interaction between the above requirements and existing Nasdaq rules, we encourage clients to read the official Nasdaq rule proposal by clicking here.

Of note, many of Nasdaq's proposed standards for Compensation Committees align with the exchange's existing requirements for Audit Committees, particularly with respect to assessing compensatory arrangements for Directors. This approach is described in detail on pages 14 and 15 of the Nasdaq rule release.

Compensation Advisor Independence

With respect to compensation advisor independence, Nasdaq chose to follow the SEC's guidance in lock-step, and proposed no additional independence factors for listed companies to consider beyond the six requirements originally provided by the SEC. For reference, the six factors enumerated by the SEC in June include:

1. Whether the compensation consulting company employing the compensation adviser is providing any other services to the company;

2. How much the compensation consulting company who employs the compensation adviser has received in fees from the company, as a percentage of the firm's total revenue;

3. What policies and procedures have been adopted by the compensation consulting company employing the compensation adviser to prevent conflicts of interest;

4. Whether the compensation adviser has any business or personal relationship with a member of the Compensation Committee;

5. Whether the compensation adviser owns any stock of the company; and

6. Whether the compensation adviser or the person employing the adviser has any business or personal relationship with an executive officer of the issuer.

Board Action Items:

Consider the adoption of a formal policy governing reviews of compensation adviser independence. Aligning policies with SEC factors (that still provide significant room for Committee discretion) could make compliance more straight forward.

Like the SEC, Nasdaq "seeks to emphasize that a Compensation Committee is not required to retain an independent compensation adviser; rather, a Compensation Committee is required only to conduct the independence analysis described in Rule 10C-1 before selecting a compensation adviser."

Timing of New Requirements

As currently proposed, Nasdaq's independence-related listing requirements are slated to become effective immediately upon SEC approval, including all requirements related to compensation adviser independence. According to Nasdaq, "to the extent a Company does not have a Compensation Committee, the provisions of this rule shall apply to the independent Directors who determine, or recommend to the Board for determination, the compensation of the chief executive officer and all other Executive Officers of the Company.

Furthermore, "companies must comply with the remaining provisions of the amended listing rules by the earlier of: (1) their second annual meeting held after the date of approval of this proposal; or (2) December 31, 2014. Until a Company is required to comply with the amended listed rules, it must continue to comply with Nasdaq's existing listing rules." Existing transition rules for recently public companies continue to apply.

Next Steps

The SEC's release of final independence standards under Section 952 of the Dodd-Frank Wall Street Reform Act brings to a close just one of the many highly anticipated compensation-related rulemaking efforts under the landmark piece of legislation. However, several outstanding issues remain, which Boards must continue to monitor in the coming months. These include final rules on clawback policies, pay-for-performance disclosures, and CEO-to-worker pay ratios, among other items.

In the near-term, now that each US exchange has released proposed listing requirements under the SEC's new independence standards, Boards must continue to monitor the SEC and relevant exchanges for the publication of final listing requirements – which are due no later than June 27, 2013. Next, Boards must define their own internal policies for assessing the independence of Compensation Committee members, followed by decisions on the extent to which they should formalize independence policies for compensation advisors.

Again, for a refresher on the SEC's final independence standards published in June, we encourage clients to read our client alert: Assessing the Impact of New SEC Compensation Committee Independence Standards.

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