

KIRKLAND ALERT

October 2012

Exchanges Propose Compensation Committee Independence and Related Rules

On September 25, 2012, NYSE and Nasdaq proposed rules to implement Dodd-Frank Act's mandate that a listed company's compensation committee consist entirely of independent directors and related matters.

With the assistance of the attached chart, companies should:

Take Inventory. Understand the general framework of the proposed rules and how the proposed rules would impact your company. A company listed on the Nasdaq would, for the first time under Nasdaq listing rules, be required to formally appoint a compensation committee of at least two independent members.

Review Compensation Committee Independence. Consider how the independence requirements under the proposed rules would impact your company's compensation committee. The exchanges made clear that, unlike the independence requirements for membership on the audit committee, directors affiliated with significant shareholders are not *per se* excluded from serving on compensation committees.

Review Compensation Committee Charter. The proposed rules would require compensation committee charters to contain specific authority and funding to retain advisers to the committee.

Review Adviser Independence. Under the proposed rules, compensation committees would be required to consider six independent factors before the committee engaged a consultant, legal counsel or other adviser. Unfortunately the proposed rules and prior SEC rulemaking provide little interpretative guidance on the six factors. As described in our June 2012 [alert](#) titled "SEC Adopts Final Compensation Committee Independence and Related Rules" and notwithstanding the transition period discussed below, companies will need to disclose in proxy statements for 2013 annual meetings whether the retention of a compensation consultant raised any conflict of interest and how such conflict is being addressed.

If adopted, a NYSE listed issuer would have until the earlier of its first annual meeting after January 15, 2014 and October 31, 2014 to comply with the new director independence rules. All other provisions of the new NYSE rules would become operative on July 1, 2013. A Nasdaq listed issuer would be required to comply with (1) compensation committee authorization and funding requirements immediately upon adoption of the new rules and (2) the remainder of the rules, at the earlier of their second annual meeting held after adoption of final rules and December 31, 2014.

Click here for a [chart](#) setting forth the key differences between NYSE and Nasdaq rule proposals.

Click here for a copy of our [Private Equity Newsletter](#), addressing the principal impact of the proposed rules on private funds.

If you have any questions about the matters addressed in this *Kirkland Alert*, please contact the following Kirkland authors or your regular Kirkland contact.

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Is a listed issuer required to have a compensation committee ?	Yes. This requirement was already in place under existing NYSE listing rules.	Yes. Companies listed on the Nasdaq would, for the first time under the proposed rules, be required to formally appoint a compensation committee of at least two independent members and adopt a written compensation committee charter (requirements which have historically applied to NYSE listed companies, and a practice which many Nasdaq listed companies had voluntarily adopted as best practices and to qualify for certain exemptions under Section 16 of the Exchange Act and Section 162(m) of the Internal Revenue Code).
How would compensation committee heightened independence be determined under the proposed rules?	<p>In addition to satisfying NYSE's general independence criteria - the board of directors must consider all factors relevant to determining whether a director has a relationship 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:</p> <ul style="list-style-type: none"> • the source of compensation of such director, including any consulting, advisory or other compensatory fee paid by the listed company to such director; and • 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. <p>Notably while NYSE proposed rules would require the board to consider sources of compensation, immaterial amounts of compensation from the listed issuer would not per se prohibit the director from service on the compensation committee as under proposed Nasdaq rules.</p>	<p>In addition to satisfying Nasdaq's general independence criteria - compensation committee members must not accept directly or indirectly any consulting, advisory or other compensation from the company or any subsidiary thereof (<u>other than</u>: (i) fees received as a member of the compensation committee, the board of directors or any other board committee; or (ii) the receipt of fixed amounts of compensation under a retirement plan, including deferred compensation, for prior service with the company (provided that such compensation is not contingent in any way on continued service)).</p> <p>In determining whether a director is eligible to serve on the compensation committee, a company's board also must consider 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.</p>
Would a director affiliated with a private fund owning a large position in a listed company act as a per se bar from serving on the compensation committee?	No. Stock ownership, by itself, is not a bar to serving on the compensation committee (i.e. unlike the independence requirements for membership on an audit committee, directors affiliated with significant shareholders are not <i>per se</i> excluded from serving on compensation committees).	
Is there a cure period for non-compliance?	Yes. Generally the cure period for failure to satisfy the heightened compensation committee independence requirements would apply until the earlier of the next annual shareholders' meeting of the listed company or one year from the occurrence of the event that caused the member to be no longer independent (Nasdaq would in addition, limit the cure period to 180 days from the	

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	event if the annual shareholders meeting occurs later than 180 days following the event). In addition, subject to certain conditions, Nasdaq has retained the ability for one non-independent director to serve on compensation committees of with at least 3 members under exceptional and limited circumstances .	
What do the proposed rules require to be contained in the company's compensation committee charter ?	<p>The proposed rules¹ would require compensation committees of listed companies be provided with authority and funding specified by Rule 10C of the Exchange Act. Namely, compensation committees would be required to be provided with:</p> <ul style="list-style-type: none"> • authority to retain compensation consultants, legal counsel and other compensation advisers; • responsibility for the appointment, compensation and oversight of the work of advisers retained by the committee; • authority to fund such advisers; and • responsibility to consider certain independence factors before selecting such advisers, other than in-house legal counsel. 	
What independence criteria would compensation committees be required to consider in selecting advisers ?	<p>The proposed rules would largely track an earlier SEC mandate requiring that a 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:</p> <ul style="list-style-type: none"> • the provision of other services to the listed company by the person that employs the compensation consultant, legal counsel or other adviser; • 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; • 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; • any business or personal relationship of the compensation consultant, legal counsel or other adviser with a member of the compensation committee; • any stock of the listed company owned by the compensation consultant, legal counsel or other adviser; and • any business or personal relationship of the compensation consultant, legal counsel, other adviser or the person employing 	

¹ In addition, due to the fact that Nasdaq listed companies would for the first time be required to formally constitute a compensation committee, Nasdaq's proposed rules would require the charter to contain certain "basic" requirements concerning: (A) the scope of the compensation committee's responsibilities, and how it carries out those responsibilities, including structure, processes and membership requirements; (B) the compensation committee's responsibility for determining, or recommending to the board for determination, the compensation of the chief executive officer and all other executive officers of the company; and (C) that the chief executive officer may not be present during voting or deliberations on his or her compensation. Existing NYSE rules already require other matters to be contained in the committee's charter.

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	<p>the adviser with an executive officer of the listed company.</p> <p>Unfortunately the proposed rules provided little interpretative guidance on the above six factors other than to note, consistent with prior SEC rulemaking, that:</p> <ul style="list-style-type: none"> • the committee would not be required to actually engage an independent adviser, or, once engaged, to follow such adviser’s advice; and • the rules do not prohibit management from separately engaging a compensation consultant, legal counsel or other adviser. <p>The compensation committee would be required to conduct the independence assessment with respect to any compensation consultant, legal counsel or other adviser that provides advice to the compensation committee, other than in-house legal counsel. See our June 2012 alert titled “SEC Adopts Final Compensation Committee Independence and Related Rules” for information about how companies will need to disclose in proxy statements for 2013 annual meetings whether the retention of a compensation consultant raised any conflict of interest (referring to the six factors discussed above) and how such conflict is being addressed.</p>	
<p>How is a smaller reporting company impacted by the proposed rules?</p>	<p>A smaller reporting company (i.e., a company with less than \$75 million of public float held by non-affiliates) would not generally be subject to the new compensation committee heightened independence requirements.</p>	
<p>How is a controlled company impacted by the proposed rules?</p>	<p>Controlled companies (i.e., a company with a 50% or more stockholder) would generally be exempt from the proposed rules.</p>	
<p>When will the proposed rules become effective?</p>	<p>A NYSE listed issuer would have until the earlier of its first annual meeting after January 15, 2014 and October 31, 2014 to comply with the new director independence standards.</p> <p>All other provisions would become operative on July 1, 2013.</p>	<p>Provisions relating to compensation committee authority and funding requirements -- would be effective immediately upon adoption of final rules (currently expected to occur at or before June 27, 2013). To the extent the company did not have a compensation committee -- the requirements would apply to the company’s independent directors responsible for compensation decisions.</p> <p>All other provisions would be required to be implemented by the company’s second annual meeting held after the date of approval of the final rules, but no later than December 31, 2014.</p> <p>During the transition period, compensation decisions would be required to be made by independent directors constituting a majority of the Board’s independent directors, or a compensation committee comprised solely of independent directors (in each case under Nasdaq’s general independence criteria).</p>