

*Required fields are shown with yellow backgrounds and asterisks.*

Page 1 of \* 97

SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, D.C. 20549  
Form 19b-4

File No.\* SR - 2012 - \* 109

Amendment No. (req. for Amendments \*)

Proposed Rule Change by NASDAQ Stock Market

Pursuant to Rule 19b-4 under the Securities Exchange Act of 1934

Initial \*



Amendment \*



Withdrawal



Section 19(b)(2) \*



Section 19(b)(3)(A) \*



Section 19(b)(3)(B) \*



Rule

Pilot

Extension of Time Period  
for Commission Action \*

Date Expires \*



19b-4(f)(1)



19b-4(f)(2)



19b-4(f)(3)



19b-4(f)(4)



19b-4(f)(5)



19b-4(f)(6)



Exhibit 2 Sent As Paper Document



Exhibit 3 Sent As Paper Document

**Description**

Provide a brief description of the proposed rule change (limit 250 characters, required when Initial is checked \*).

A proposed rule change to modify the listing rules for compensation committees to comply with Rule 10C-1 under the Exchange Act and make other related changes.

**Contact Information**

Provide the name, telephone number and e-mail address of the person on the staff of the self-regulatory organization prepared to respond to questions and comments on the proposed rule change.

First Name \* Erika

Last Name \* Moore

Title \*

Associate General Counsel

E-mail \*

erika.moore@nasdaqomx.com

Telephone \*

(301) 978-8490

Fax

(301) 978-8472

**Signature**

Pursuant to the requirements of the Securities Exchange Act of 1934,

has duly caused this filing to be signed on its behalf by the undersigned thereunto duly authorized officer.

Date 09/25/2012

By Edward S. Knight

(Name \*)

Executive Vice President and General Counsel

(Title \*)

NOTE: Clicking the button at right will digitally sign and lock this form. A digital signature is as legally binding as a physical signature, and once signed, this form cannot be changed.

Edward S Knight,

SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, D.C. 20549

For complete Form 19b-4 instructions please refer to the EFFS website.

**Form 19b-4 Information (required)**

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The self-regulatory organization must provide all required information, presented in a clear and comprehensible manner, to enable the public to provide meaningful comment on the proposal and for the Commission to determine whether the proposal is consistent with the Act and applicable rules and regulations under the Act.

**Exhibit 1 - Notice of Proposed Rule Change (required)**

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The Notice section of this Form 19b-4 must comply with the guidelines for publication in the Federal Register as well as any requirements for electronic filing as published by the Commission (if applicable). The Office of the Federal Register (OFR) offers guidance on Federal Register publication requirements in the Federal Register Document Drafting Handbook, October 1998 Revision. For example, all references to the federal securities laws must include the corresponding cite to the United States Code in a footnote. All references to SEC rules must include the corresponding cite to the Code of Federal Regulations in a footnote. All references to Securities Exchange Act Releases must include the release number, release date, Federal Register cite, Federal Register date, and corresponding file number (e.g., SR-[SRO]-xx-xx). A material failure to comply with these guidelines will result in the proposed rule change being deemed not properly filed. See also Rule 0-3 under the Act (17 CFR 240.0-3)

**Exhibit 2 - Notices, Written Comments, Transcripts, Other Communications**

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Copies of notices, written comments, transcripts, other communications. If such documents cannot be filed electronically in accordance with Instruction F, they shall be filed in accordance with Instruction G.

**Exhibit 3 - Form, Report, or Questionnaire**

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Copies of any form, report, or questionnaire that the self-regulatory organization proposes to use to help implement or operate the proposed rule change, or that is referred to by the proposed rule change.

**Exhibit 4 - Marked Copies**

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The full text shall be marked, in any convenient manner, to indicate additions to and deletions from the immediately preceding filing. The purpose of Exhibit 4 is to permit the staff to identify immediately the changes made from the text of the rule with which it has been working.

**Exhibit 5 - Proposed Rule Text**

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The self-regulatory organization may choose to attach as Exhibit 5 proposed changes to rule text in place of providing it in Item I and which may otherwise be more easily readable if provided separately from Form 19b-4. Exhibit 5 shall be considered part of the proposed rule change.

**Partial Amendment**

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If the self-regulatory organization is amending only part of the text of a lengthy proposed rule change, it may, with the Commission's permission, file only those portions of the text of the proposed rule change in which changes are being made if the filing (i.e. partial amendment) is clearly understandable on its face. Such partial amendment shall be clearly identified and marked to show deletions and additions.

1. Text of Proposed Rule Change

(a) Pursuant to the provisions of Section 19(b)(1) under the Securities Exchange Act of 1934 (“Exchange Act”),<sup>1</sup> and Rule 19b-4 thereunder,<sup>2</sup> The NASDAQ Stock Market LLC (“Nasdaq”) is filing with the Securities and Exchange Commission (“Commission” or “SEC”) a proposed rule change to modify the listing rules for compensation committees to comply with Rule 10C-1 under the Exchange Act and make other related changes.

The text of the proposed rule change is attached in Exhibit 5.

(b) Not applicable.

(c) Not applicable.

2. Procedures of the Self-Regulatory Organization

The Board of Directors of Nasdaq approved the proposed rule change on September 14, 2012, which authorized the filing of the rule change with the Commission. No other action by Nasdaq is necessary for the filing of the rule change.

Nasdaq will implement the proposed rule upon approval. Proposed Nasdaq Listing Rule 5605(d)(3), which requires compensation committees to have the specific responsibilities and authority necessary to comply with Rule 10C-1(b)(2), (3) and (4)(i)-(vi) under the Exchange Act, shall be effective immediately. 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.

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<sup>1</sup> 15 U.S.C. 78s(b)(1).

<sup>2</sup> 17 CFR 240.19b-4.

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.

Questions regarding this rule filing may be directed to Erika J. Moore, Associate General Counsel, Nasdaq, at (301) 978-8490 (telephone) or (301) 978-8472 (fax).

3. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

a. Purpose

Section 952 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the "Dodd-Frank Act")<sup>3</sup> added Section 10C to the Exchange Act.<sup>4</sup> Section 10C required the Commission to direct the national securities exchanges, including Nasdaq, and national securities associations to prohibit the listing of any equity security of an issuer, with certain exemptions, that does not comply with Section 10C's requirements relating to compensation committees and advisers. To effect this requirement, the Commission has adopted Rule 10C-1 under the Exchange Act, which became effective on July 27, 2012. Rule 10C-1 requires each national securities exchange and national securities association to provide to the Commission, no later than September 25, 2012, proposed rules or rule amendments that comply with the requirements of Rule 10C-1.<sup>5</sup>

Rule 10C-1 generally requires that:

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<sup>3</sup> Pub. L. No. 111-203, 124 Stat. 1376 (2010).

<sup>4</sup> 15 U.S.C. 78j-3.

<sup>5</sup> See 17 CFR 240.10C-1(a)(4)(i).

- each member of the compensation committee of a listed issuer must be an independent member of the board of directors;
- in determining independence requirements for compensation committee members, exchanges must consider relevant factors, including, but not limited to:
  - the source of compensation of a member, including any consulting, advisory or other compensatory fee paid by the issuer to such member; and
  - whether the member is affiliated with the issuer, a subsidiary of the issuer or an affiliate of a subsidiary of the issuer;
- the compensation committee must have the authority to retain or obtain the advice of a compensation consultant, independent legal counsel or other compensation adviser;
- the listed issuer must provide for appropriate funding, as determined by the compensation committee, for payment of reasonable compensation to such compensation advisers;
- the compensation committee may select such compensation advisers only after taking into consideration six independence factors that are enumerated in Rule 10C-1, as well as any other factors identified by an exchange; and
- certain categories of issuers, including, but not limited to, controlled companies and smaller reporting companies, are generally exempt from all of Rule 10C-1, while other categories of issuers, including, but not limited

to, foreign private issuers that provide certain disclosures, are specifically exempt from the requirement to have a fully independent compensation committee.

#### General Overview of Nasdaq's Proposals

Nasdaq is proposing to modify its compensation-related listing rules, as required by Rule 10C-1. Generally, Nasdaq's proposals provide that:

- Companies<sup>6</sup> must have a compensation committee consisting of at least two members, each of whom must be an Independent Director<sup>7</sup> 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 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;

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<sup>6</sup> "Company" means "the issuer of a security listed or applying to list on Nasdaq." Nasdaq Listing Rule 5005(a)(6).

<sup>7</sup> For a discussion of the definition of the term "Independent Director," see the section entitled "Compensation Committee Composition – General Independence Definition" below. Notwithstanding any of the proposed changes, and consistent with Nasdaq's existing listing rules, a Company's board has the responsibility to make an affirmative determination that no Independent Director has a relationship that, in the opinion of the board, would interfere with the exercise of independent judgment in carrying out the responsibilities of a director.

- 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;
- 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<sup>8</sup> 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

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<sup>8</sup> Smaller Reporting Company is defined in Rule 12b-2 under the Exchange Act.

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.

Rule 10C-1 requires Nasdaq to include in its submission: (i) a review of whether and how its existing or proposed listing rules satisfy the requirements of Rule 10C-1; (ii) a discussion of the consideration of factors relevant to compensation committee independence conducted by Nasdaq; and (iii) the definition of independence applicable to compensation committee members that Nasdaq proposes to adopt or retain in light of such review.<sup>9</sup> Nasdaq's proposals and its underlying analysis are discussed in depth below.

#### Requirement to Have a Compensation Committee

Nasdaq's current listing rules require that compensation of the chief executive officer and all other Executive Officers<sup>10</sup> of a Company must be determined, or recommended to the board for determination, either by: (i) a compensation committee comprised solely of Independent Directors; or (ii) Independent Directors constituting a majority of the board's Independent Directors in a vote in which only Independent Directors participate (the "Alternative").<sup>11</sup>

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<sup>9</sup> See 17 CFR 240.10C-1(a)(4)(i).

<sup>10</sup> "Executive Officer" is defined as an officer "covered in Rule 16a-1(f) under the [Exchange] Act." Nasdaq Listing Rule 5605(a)(1).

<sup>11</sup> See Nasdaq Listing Rules 5605(d)(1) and (2).



Although it was not required to do so by Rule 10C-1,<sup>12</sup> Nasdaq considered whether the Alternative remains appropriate given the heightened importance of compensation decisions in today's corporate governance environment. Since responsibility for executive compensation decisions is one of the most important responsibilities entrusted to a board of directors, Nasdaq believes that there are benefits from a board having a standing committee dedicated solely to oversight of executive compensation. Specifically, directors on a standing compensation committee may develop expertise in a Company's executive compensation program in the same way that directors on a standing audit committee develop expertise in a Company's accounting and financial reporting processes. In addition, a formal committee structure may help promote accountability to stockholders for executive compensation decisions.

Nasdaq also considered whether eliminating the Alternative would pose an undue hardship on Nasdaq-listed Companies. Only a small number of Companies rely on the Alternative,<sup>13</sup> and since the Alternative requires certain executive compensation decisions to be determined, or recommended to the board for determination, by a majority of the board's Independent Directors, these Companies already have some directors who focus on executive compensation. In addition, Nasdaq would allow a transition period for these Companies to implement a standing compensation committee. As a result, Nasdaq does not believe that eliminating the Alternative would be unduly burdensome to Companies.

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<sup>12</sup> See Securities Exchange Act Release No. 67220 (June 20, 2012), 77 FR 38422, 38425 (June 27, 2012) (the "Adopting Release") (stating that "[t]he final rule will not require a listed issuer to have a compensation committee or a committee that performs functions typically assigned to a compensation committee.")

<sup>13</sup> As of June 30, 2012, only 25 of 2,636 Nasdaq-listed Companies relied on the Alternative in lieu of having a standing compensation committee.

As a result, Nasdaq proposes to eliminate the Alternative and require Nasdaq-listed Companies to have a standing compensation committee with the responsibility for determining, or recommending to the full board for determination, the compensation of the chief executive officer and all other Executive Officers of the Company.

#### Compensation Committee Size

Nasdaq's current listing rules do not impose size requirements on any board committees, other than the audit committee, which must consist of at least three members.<sup>14</sup> As a result, it is possible to have a compensation committee comprised of only one member under Nasdaq's current listing rules.

Although it was not required to do so by Rule 10C-1, Nasdaq considered whether it is appropriate to impose a minimum size requirement on a compensation committee. Given the importance of compensation decisions to stockholders, Nasdaq believes that it is appropriate to have more than one director responsible for these decisions and that therefore, a compensation committee should consist of at least two members. Nasdaq then considered whether to require compensation committees to adhere to the same size requirement as audit committees and have a minimum of three members. However, Nasdaq was concerned that it might be difficult for Companies, especially smaller Companies, to comply with a requirement to have a three-member compensation committee, in addition to a three-member audit committee.

Nasdaq also considered whether imposing a minimum size requirement on a compensation committee would be unduly burdensome to Nasdaq-listed Companies, especially in combination with the proposal to eliminate the Alternative, as discussed

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<sup>14</sup> See Nasdaq Listing Rule 5605(c)(2)(A).

above. Since only a small number of Companies currently have a compensation committee of one member and Nasdaq would allow a transition period to add an additional member, Nasdaq does not believe that requiring a compensation committee to consist of at least two members would be an undue hardship for Nasdaq-listed Companies.<sup>15</sup>

As a result, Nasdaq proposes to require a compensation committee of a Company to consist of at least two members of the board of directors.

Compensation Committee Composition – General Independence Definition

Nasdaq's current listing rules require a compensation committee to be comprised solely of Independent Directors, as defined in Nasdaq Listing Rule 5605(a)(2).<sup>16</sup> This definition includes a two-part test for independence. First, there are certain categories of directors who cannot be considered independent, including:

- a director who is an Executive Officer or employee of the Company;<sup>17</sup>
- a director who is, or at any time during the past three years was, employed by the Company;<sup>18</sup>
- a director who accepted or who has a Family Member<sup>19</sup> who accepted any compensation from the Company in excess of \$120,000 during any period

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<sup>15</sup> As of June 30, 2012, only 26 of 2,636 Nasdaq-listed Companies had a compensation committee of only one member.

<sup>16</sup> See Nasdaq Listing Rules 5605(d)(1) and (2).

<sup>17</sup> See Nasdaq Listing Rule 5605(a)(2). The rule's reference to the term "Company" includes any parent or subsidiary of the Company. The term "parent or subsidiary" is intended to cover entities the Company controls and consolidates with the Company's financial statements as filed with the Commission (but not if the Company reflects such entity solely as an investment in its financial statements). See IM-5605.

<sup>18</sup> See Nasdaq Listing Rule 5605(a)(2)(A).

of twelve consecutive months within the three years preceding the determination of independence;<sup>20</sup>

- a director who is a Family Member of an individual who is, or at any time during the past three years was, employed by the Company as an Executive Officer;<sup>21</sup>
- a director who is, or has a Family Member who is, a partner in, or a controlling Shareholder<sup>22</sup> or an Executive Officer of, any organization to which the Company made, or from which the Company received, payments for property or services in the current or any of the past three fiscal years that exceed 5% of the recipient's consolidated gross revenues for that year, or \$200,000, whichever is more;<sup>23</sup>
- a director of the Company who is, or has a Family Member who is, employed as an Executive Officer of another entity where at any time

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<sup>19</sup> “Family Member” is defined as “a person’s spouse, parents, children and siblings, whether by blood, marriage or adoption, or anyone residing in such person’s home.” Nasdaq Listing Rule 5605(a)(2).

<sup>20</sup> See Nasdaq Listing Rule 5605(a)(2)(B). This prohibition includes exceptions for: (i) compensation for board or board committee service; (ii) compensation paid to a Family Member who is an employee (other than an Executive Officer) of the Company; or (iii) benefits under a tax-qualified retirement plan, or non-discretionary compensation.

<sup>21</sup> See Nasdaq Listing Rule 5605(a)(2)(C).

<sup>22</sup> “Shareholder” is defined as “a record or beneficial owner of a security listed or applying to list. For purposes of [Nasdaq’s Listing Rules], the term ‘Shareholder’ includes, for example, a limited partner, the owner of a depository receipt, or unit.” Nasdaq Listing Rule 5005(a)(38).

<sup>23</sup> See Nasdaq Listing Rule 5605(a)(2)(D). This prohibition includes exceptions for payments: (i) arising solely from investments in the Company’s securities; or (ii) under non-discretionary charitable contribution matching programs.

during the past three years any of the Executive Officers of the Company serve on the compensation committee of such other entity;<sup>24</sup> or

- a director who is, or has a Family Member who is, a current partner of the Company's outside auditor, or was a partner or employee of the Company's outside auditor who worked on the Company's audit at any time during any of the past three years.<sup>25</sup>

Second, a Company's board of directors must make an affirmative determination that each Independent Director has no relationship that, in the opinion of the board, would interfere with the exercise of independent judgment in carrying out the responsibilities of a director.<sup>26</sup>

Nasdaq proposes to continue unchanged its existing requirement that a compensation committee be comprised solely of Independent Directors, as defined in Nasdaq Listing Rule 5605(a)(2).

#### Compensation Committee Composition – Compensatory Fees

Rule 10C-1 requires that in determining the independence requirements for compensation committee members, Nasdaq must consider relevant factors, including, but not limited to, the source of compensation of a member, including any consulting,

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<sup>24</sup> See Nasdaq Listing Rule 5605(a)(2)(E).

<sup>25</sup> See Nasdaq Listing Rule 5605(a)(2)(F). In the case of an investment company, in lieu of the prohibitions in Nasdaq Listing Rule 5605(a)(2)(A) – (F), a director cannot be considered independent if he or she is an "interested person" of the Company as defined in Section 2(a)(19) of the Investment Company Act of 1940, other than in his or her capacity as a member of the board of directors or any board committee.

<sup>26</sup> See Nasdaq Listing Rule 5605(a)(2) and IM-5605.

advisory or other compensatory fee paid by the issuer to the member.<sup>27</sup> In considering this particular factor, Nasdaq reviewed its current listing rules relating to compensatory fees. As outlined above, Nasdaq's current listing rules require compensation committee members to be Independent Directors. Independent Director is defined to exclude any director who: (i) accepted any compensation from the Company in excess of \$120,000 during any period of twelve consecutive months within the prior three years; or (ii) is a partner in, or a controlling Shareholder or an Executive Officer of, any organization to which the Company made, or from which the Company received, payments for property or services in the current or any of the past three fiscal years that exceed 5% of the recipient's consolidated gross revenues for that year, or \$200,000, whichever is more.<sup>28</sup> As a result, directors who receive compensatory fees from a Company below these thresholds may serve on a compensation committee under Nasdaq's current listing rules.

This is in contrast to Nasdaq's current listing rules relating to audit committees, which require audit committee members to meet the criteria for independence set forth in Rule 10A-3(b)(1) under the Exchange Act, subject to certain exemptions.<sup>29</sup> Rule 10A-3(b)(1) prohibits an audit committee member from accepting directly or indirectly any consulting, advisory or other compensatory fee from an issuer or any subsidiary, with certain exemptions.

After reviewing its current listing rules, Nasdaq concluded that there is no compelling justification to have different independence standards for audit and compensation committee members with respect to the acceptance of compensatory fees

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<sup>27</sup> See 17 CFR 240.10C-1(b)(1)(ii)(A).

<sup>28</sup> See Nasdaq Listing Rules 5605(a)(2)(B) and (D).

<sup>29</sup> See Nasdaq Listing Rule 5605(c)(2)(A)(ii).

from a Company. Accordingly, Nasdaq proposes to adopt the same standard for compensation committee members that applies to audit committee members under Rule 10A-3 under the Exchange Act with respect to compensatory fees. Specifically, Nasdaq's proposal prohibits a compensation committee member from accepting directly or indirectly any consulting, advisory or other compensatory fee from an issuer or any subsidiary. As in Rule 10A-3, compensatory fees shall not include: (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).<sup>30</sup> Also similar to Rule 10A-3, the proposed requirement applicable to compensation committee members will not include a "look-back" period.<sup>31</sup> Accordingly, the prohibition on the receipt of any consulting, advisory or other compensatory fee by a compensation committee member begins with the member's term of service on the compensation committee.<sup>32</sup>

#### Compensation Committee Composition – Affiliation

Rule 10C-1 requires that in determining the independence requirements for compensation committee members, Nasdaq also must consider whether a member is

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<sup>30</sup> See 17 CFR 240.10A-3(b)(1).

<sup>31</sup> See Securities Exchange Act Release No. 47654 (April 9, 2003), 68 FR 18788, 18792 (April 16, 2003) (stating that "[t]he final rule, like [the] proposal, applies the prohibitions only to current relationships with the audit committee member and related persons. They do not extend to a 'look back' period before appointment to the audit committee....")

<sup>32</sup> Nasdaq notes, however, that as discussed above, compensation committee members must be Independent Directors as defined in Nasdaq Listing Rule 5605(a)(2). Each of the bright-line tests in this definition includes a three-year "lookback" period. See Nasdaq Listing Rule 5605(a)(2).

affiliated with the issuer, a subsidiary of the issuer or an affiliate of a subsidiary of the issuer.<sup>33</sup> In considering this particular factor, Nasdaq reviewed its current listing rules relating to affiliation. As outlined above, Nasdaq's current listing rules require compensation committee members to be Independent Directors. The definition of the term "Independent Director" does not refer to affiliation, although the definition does exclude certain individuals who may be considered affiliates from being an Independent Director. For example, any director who is an Executive Officer of the Company cannot be considered an Independent Director.<sup>34</sup> Significantly, the Interpretive Material to Nasdaq's definition of Independent Director states that "[b]ecause Nasdaq does not believe that ownership of Company stock by itself would preclude a board finding of independence, it is not included in the aforementioned objective factors."<sup>35</sup>

Beyond the definition of Independent Director, Nasdaq's current listing rules relating to audit committees require audit committee members to meet the criteria for independence set forth in Rule 10A-3(b)(1) under the Exchange Act, subject to certain exemptions.<sup>36</sup> Rule 10A-3(b)(1) prohibits an audit committee member from being an affiliated person of the issuer or any subsidiary thereof. The term "affiliate" means "a person that directly, or indirectly through one or more intermediaries, controls, or is controlled by, or is under common control with, the person specified."<sup>37</sup> However, Rule 10A-3 includes a safe harbor for a person that is not: (i) the beneficial owner, directly or

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<sup>33</sup> See 17 CFR 240.10C-1(b)(1)(ii)(B).

<sup>34</sup> See Nasdaq Listing Rule 5605(a)(2).

<sup>35</sup> IM-5605.

<sup>36</sup> See Nasdaq Listing Rule 5605(c)(2)(A)(ii).

<sup>37</sup> See 17 CFR 240.10A-3(e)(1).



indirectly, of more than 10% of any class of voting equity securities of the specified person; and (ii) an executive officer of a specified person.<sup>38</sup>

After reviewing its current listing rules, Nasdaq considered whether to propose that compensation committee members must meet the same standard applicable to audit committee members under Rule 10A-3 under the Exchange Act with respect to affiliation, similar to its proposal with respect to compensatory fees. However, Nasdaq concluded that such a blanket prohibition would be inappropriate for compensation committees. In fact, Nasdaq believes that it may be appropriate for certain affiliates, such as representatives of significant stockholders, to serve on compensation committees since their interests are likely aligned with those of other stockholders in seeking an appropriate executive compensation program.

As a result, Nasdaq proposes that Companies' boards of directors should consider affiliation in making an eligibility determination for compensation committee members, but it does not propose bright-line rules around this factor. In making this eligibility determination, a Company's board specifically 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. In performing this analysis, a board of directors is not required to apply a "look-back" period, and is therefore required to consider affiliation only with respect to relationships that occur during an individual's term of service as a compensation committee member.

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<sup>38</sup>Id.

A board may conclude that it is appropriate for a director who is an affiliate to serve on the compensation committee. While this differs from the requirement applicable to audit committee members, Nasdaq could identify no compelling policy justification for precluding all affiliates, such as owners of a Company, even those with very large stakes, from serving on the compensation committee.

#### Compensation Committee Composition – Other

Rule 10C-1 permits Nasdaq to consider other relevant factors in determining the independence requirements for compensation committee members.<sup>39</sup> After reviewing its current and proposed listing rules, Nasdaq concluded that these rules are sufficient to ensure the independence of compensation committee members. Therefore, Nasdaq determined not to propose further independence requirements.

#### Exceptional and Limited Circumstances Exception

With minor edits, Nasdaq proposes to retain its existing exception that allows a Company to have a non-Independent Director serve on the compensation committee under exceptional and limited circumstances.<sup>40</sup> Under this exception, if a compensation committee consists of at least three members, one director who is not an Independent Director and is not currently an Executive Officer or employee or a Family Member of an Executive Officer, may be appointed to the compensation committee if the board, under exceptional and limited circumstances, determines that such individual's membership on the committee is required by the best interests of the Company and its Shareholders. A Company that relies on this exception must disclose either on or through the Company's website or in the proxy statement for the next annual meeting subsequent to such

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<sup>39</sup> See 17 CFR 240.10C-1(b)(1)(ii).

<sup>40</sup> See Nasdaq Listing Rule 5605(d)(3).

determination (or, if the Company does not file a proxy, in its Form 10-K or 20-F), the nature of the relationship and the reasons for the determination. In addition, the Company must provide any disclosure required by Instruction 1 to Item 407(a) of Regulation S-K regarding its reliance on this exception. A member appointed under this exception may not serve longer than two years.

In addition to the existing exception for compensation committees, Nasdaq's current listing rules include similar exceptions for audit and nominations committees.<sup>41</sup> While these exceptions are used infrequently by Nasdaq-listed Companies,<sup>42</sup> Nasdaq believes they are an important means to allow Companies flexibility as to board and committee membership and composition in unusual circumstances, which may be particularly important for smaller Companies.

Nasdaq would allow a Company to avail itself of the exception even for a director who fails the new requirements adopted pursuant to Rule 10C-1.

#### Cure Period

Consistent with Rule 10C-1, Nasdaq's proposal provides Companies with an opportunity to cure defects in the composition of compensation committees.<sup>43</sup> The

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<sup>41</sup> See Nasdaq Listing Rules 5605(c)(2)(B) and 5605(e)(3). Nasdaq recently amended the exceptions for all three committees to allow a Company to rely on the exception for a non-Independent Director who is a Family Member of a non-executive employee of the Company. See Securities Exchange Act Release No. 67468 (July 19, 2012), 77 FR 43618 (July 25, 2012) (SR-NASDAQ-2012-062). Nasdaq proposes to retain this aspect of the exception for compensation committees, as well as audit and nominations committees.

<sup>42</sup> On June 30, 2012, ten of 2,636 Nasdaq-listed Companies were using one of these exceptions: six Companies for the audit committee and four Companies for the nominations committee. No Companies were using this exception for the compensation committee.

<sup>43</sup> See 17 CFR 240.10C-1(a)(3).

proposed cure period is copied from the cure period in Nasdaq's current listing rules for noncompliance with the requirement to have a majority independent board.<sup>44</sup>

Under Nasdaq's proposal, if a Company fails to comply with the compensation committee composition requirements due to one vacancy, or one compensation committee member ceases to be independent due to circumstances beyond the member's reasonable control, the Company shall regain compliance by the earlier of the next annual shareholders meeting or one year from the occurrence of the event that caused the noncompliance. However, if the annual shareholders meeting occurs no later than 180 days following the event that caused the noncompliance, the Company shall instead have 180 days from such event to regain compliance. This provides a Company at least 180 days to cure noncompliance and would typically allow a Company to regain compliance in connection with its next annual meeting. A Company relying on this provision shall provide notice to Nasdaq immediately upon learning of the event or circumstance that caused the noncompliance.

#### Compensation Committee Charter

Nasdaq proposes to require each Company to certify that it has adopted a formal written compensation committee charter and that the compensation committee will review and reassess the adequacy of the formal written charter on an annual basis.<sup>45</sup> This proposal is similar to Nasdaq's current requirement for Companies to certify as to the

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<sup>44</sup> See Nasdaq Listing Rule 5605(b)(1)(A).

<sup>45</sup> Smaller Reporting Companies may adopt either a formal written compensation committee charter or a board resolution that specifies the committee's responsibilities and authority, except Smaller Reporting Companies are not required to specify the specific compensation responsibilities and authority set forth in proposed Nasdaq Listing Rule 5605(d)(3). For further discussion, see the section entitled "Smaller Reporting Companies" below.

adoption of a formal written audit committee charter, except that the proposed requirement for annual review and reassessment of the adequacy of the compensation committee charter is written prospectively, rather than retrospectively.<sup>46</sup> In other words, the proposed compensation committee charter requirement states that the compensation committee will review and reassess the adequacy of the charter on an annual basis, while the current audit committee charter requirement states that the audit committee has reviewed and reassessed the adequacy of the charter on an annual basis.<sup>47</sup>

Nasdaq proposes that the compensation committee charter must specify:

- the scope of the compensation committee's responsibilities, and how it carries out those responsibilities, including structure, processes and membership requirements;
- 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;
- that the chief executive officer of the Company may not be present during voting or deliberations by the compensation committee on his or her compensation; and

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<sup>46</sup> See Nasdaq Listing Rule 5605(c)(1).

<sup>47</sup> Nasdaq proposes to make a conforming change to its audit committee charter requirement to clarify that Companies' annual review and reassessment of the audit committee charter should be prospective. This is consistent with Nasdaq's current interpretation of its audit committee charter requirement. By proposing this amendment, Nasdaq seeks to minimize differences between the audit committee and compensation committee charter requirements and to eliminate potential questions as to whether Nasdaq intended a discrepancy between these two requirements.

- the specific compensation committee responsibilities and authority set forth in proposed Nasdaq Listing Rule 5605(d)(3), which implements the requirements of Section 10C(b)-(e) of the Exchange Act and Rule 10C-1(b)(2), (3) and (4)(i)-(vi) thereunder.

The requirement for the charter to specify the scope of the compensation committee's responsibilities, and how it carries out those responsibilities, including structure, processes and membership requirements, is copied from Nasdaq's similar listing rule relating to audit committee charters.<sup>48</sup>

The requirement for the charter to specify 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, is based upon Nasdaq's current compensation-related listing rules.<sup>49</sup> These listing rules require that the compensation of a Company's chief executive officer and all other Executive Officers must be determined by (i) a compensation committee comprised solely of Independent Directors or (ii) the Independent Directors constituting a majority of the board's Independent Directors in a vote in which only Independent Directors participate. As discussed above, Nasdaq proposes to eliminate the Alternative, and therefore, the compensation of a Company's chief executive officer and all other Executive Officers must be determined, or recommended to the board for determination, by a compensation committee comprised of Independent Directors. Going forward, Nasdaq proposes to implement this requirement by requiring Companies to include it in their formal written compensation committee charters.

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<sup>48</sup> See Nasdaq Listing Rule 5605(c)(1)(A).

<sup>49</sup> See Nasdaq Listing Rules 5605(d)(1) and (2).

The requirement for the charter to specify that the chief executive officer of the Company may not be present during voting or deliberations by the compensation committee on his or her compensation is based upon Nasdaq's current compensation-related listing rules.<sup>50</sup> Going forward, Nasdaq proposes to implement this requirement by requiring Companies to include it in their formal written compensation committee charters.

Finally, the requirement for the charter to specify the specific compensation committee responsibilities and authority set forth in proposed Nasdaq Listing Rule 5605(d)(3) is modeled after Nasdaq's similar listing rule relating to audit committee charters.<sup>51</sup> Proposed Nasdaq Listing Rule 5605(d)(3) implements the requirements of Section 10C(b)-(e) of the Exchange Act and Rule 10C-1(b)(2), (3) and (4)(i)-(vi) thereunder. Specifically, the proposed listing rule states that a compensation committee must have the specific compensation committee responsibilities and authority necessary to comply with Rule 10C-1(b)(2), (3) and (4)(i)-(vi) relating to the: (i) authority to retain compensation consultants, independent legal counsel and other compensation advisers;

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<sup>50</sup> See Nasdaq Listing Rule 5605(d)(1).

<sup>51</sup> See Nasdaq Listing Rule 5605(c)(1)(D), which requires that an audit committee charter set forth the specific audit committee responsibilities and authority set forth in Nasdaq Listing Rule 5605(c)(3). Nasdaq Listing Rule 5605(c)(3) states that an audit committee must have the specific responsibilities and authority necessary to comply with Rule 10A-3(b)(2), (3), (4) and (5) under the Exchange Act, with certain exemptions. Rule 10A-3(b)(2), (3), (4) and (5) under the Exchange Act concerns responsibilities relating to: (i) registered public accounting firms; (ii) complaints relating to accounting, internal accounting controls or auditing matters; (iii) authority to engage advisors; and (iv) funding as determined by the audit committee.

(ii) authority to fund such advisers; and (iii) responsibility to consider certain independence factors before selecting such advisers, other than in-house legal counsel.<sup>52</sup>

Rule 10C-1 permits Nasdaq to identify other relevant independence factors that a compensation committee must consider when selecting a compensation consultant, legal counsel or other adviser.<sup>53</sup> Nasdaq considered whether to adopt other independence factors, but ultimately concluded that the six independence factors enumerated in Rule 10C-1 will provide compensation committees with a broad and sufficient range of facts and circumstances to consider in making an independence determination. Like the Commission, 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.<sup>54</sup>

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<sup>52</sup> The independence factors include: (i) the provision of other services to the issuer by the person that employs the adviser (the “Employer”); (ii) the amount of fees received from the issuer by the Employer, as a percentage of the total revenue of the Employer; (iii) the policies and procedures of the Employer that are designed to prevent conflicts of interest; (iv) any business or personal relationship of the adviser with a member of the compensation committee; (v) any stock of the issuer owned by the adviser; and (vi) any business or personal relationship of the adviser or the Employer with an executive officer of the issuer. See 17 CFR 240.10C-1(b)(4).

<sup>53</sup> Id.

<sup>54</sup> See the Adopting Release, at 38432-3 (stating that “neither the [Dodd-Frank] Act nor [Rule 10C-1] requires a compensation adviser to be independent, only that the compensation committee consider the enumerated independence factors before selecting a compensation adviser. Compensation committees may select any compensation adviser they prefer, including ones that are not independent, after considering the six independence factors outlined in the [Rule 10C-1].”)



### Exemptions

Rule 10C-1 allows the national securities exchanges to exempt from the listing rules adopted pursuant to Rule 10C-1 certain categories of issuers, as the national securities exchange determines is appropriate, taking into consideration, among other relevant factors, the potential impact of the listing rules on smaller reporting issuers.<sup>55</sup> Nasdaq proposes that its existing exemptions from the compensation-related listing rules remain generally unchanged. Nasdaq's current listing rules include exemptions for: asset-backed issuers and other passive issuers,<sup>56</sup> cooperatives,<sup>57</sup> limited partnerships,<sup>58</sup> management investment companies<sup>59</sup> and Controlled Companies.<sup>60</sup> For the same reasons

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<sup>55</sup> See 17 CFR 240.10C-1(b)(5).

<sup>56</sup> See Nasdaq Listing Rule 5615(a)(1). Asset-backed issuers and other passive issuers have traditionally been exempt from Nasdaq's compensation-related listing rules because these issuers do not have a board of directors or persons acting in a similar capacity and their activities are limited to passively owning or holding (as well as administering and distributing amounts in respect of) securities, rights, collateral or other assets on behalf of or for the benefit of the holders of the listed securities. See IM-5615-1.

<sup>57</sup> See Nasdaq Listing Rule 5615(a)(2). Certain member-owned cooperatives that list their preferred stock are required to have their common stock owned by their members. Because of their unique structure and the fact that they do not have a publicly traded class of common stock, these entities have traditionally been exempt from Nasdaq's compensation-related listing rules. See IM-5615-2.

<sup>58</sup> See Nasdaq Listing Rule 5615(a)(4). Nasdaq's compensation-related listing rules historically have not been applied to limited partnerships because the structure of these entities requires that public investors have limited rights and that the general partners make all significant decisions about the operation of the limited partnership. As such, limited partners do not expect to have a voice in the operations of the partnership. Limited partnerships also are exempt from the independence requirements of Rule 10C-1. See 17 CFR 240.10C-1(b)(1)(iii)(A)(1).

<sup>59</sup> See Nasdaq Listing Rule 5615(a)(5). Management investment companies registered under the Investment Company Act of 1940 are already subject to a pervasive system of federal regulation in certain areas of corporate governance, and as a result, these entities have traditionally been exempt from Nasdaq's compensation-related listing rules. See IM-5615-4. Open-end management

that these categories of Companies have traditionally been exempt from Nasdaq's compensation-related listing rules, Nasdaq proposes that they continue to be exempt from its revised listing rules relating to compensation committees.

In addition, Nasdaq's current listing rules provide that a Foreign Private Issuer may follow its home country practice in lieu of Nasdaq's compensation-related listing rules if the Foreign Private Issuer discloses in its annual reports filed with the Commission each requirement that it does not follow and describes the home country practice followed by the Company in lieu of such requirements.<sup>61</sup> Alternatively, a Foreign Private Issuer that is not required to file its annual report with the Commission on Form 20-F may make this disclosure only on its website. Nasdaq proposes that a Foreign Private Issuer continue to be allowed to follow its home country practice in lieu of Nasdaq's revised listing rules relating to compensation committees if the Foreign

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investment companies registered under the Investment Company Act of 1940 also are exempt from the independence requirements of Rule 10C-1. See 17 CFR 240.10C-1(b)(1)(iii)(A)(3).

<sup>60</sup> See Nasdaq Listing Rule 5615(c). This exemption recognizes that majority Shareholders, including parent companies, have the right to select directors and control certain key decisions, such as executive officer compensation, by virtue of their ownership rights. See IM-5615-5. A Controlled Company is defined as "a Company of which more than 50% of the voting power for the election of directors is held by an individual, a group or another company." Nasdaq Listing Rule 5615(c)(1). Controlled Companies also are exempt from all of the requirements of Rule 10C-1. See 17 CFR 240.10C-1(b)(5)(ii).

<sup>61</sup> See Nasdaq Listing Rule 5615(a)(3). Under Nasdaq's listing rules, Foreign Private Issuer has the same meaning as under Rule 3b-4 under the Exchange Act. See Nasdaq Listing Rule 5005(a)(18). Nasdaq's listing rules have traditionally provided qualified exemptions for foreign private issuers so that such issuers are not required to do any act that is contrary to a law, rule or regulation of any public authority exercising jurisdiction over such issuer or that is contrary to generally accepted business practices in the issuer's country of domicile, except to the extent such exemptions would be contrary to the public securities laws. See Securities Exchange Act Release No. 48745 (November 4, 2003), 68 FR 64154, 64165 (November 12, 2003) (SR-NASD-2002-138).

Private Issuer provides the disclosures described above. Nasdaq also proposes to add an additional disclosure requirement for any Foreign Private Issuer that follows its home country practice in lieu of the requirement to have an independent compensation committee to disclose in its annual reports filed with the Commission the reasons why it does not have such a committee.<sup>62</sup>

#### Phase-In Schedules

Nasdaq proposes that its existing phase-in schedules for the requirements relating to compensation committee composition remain generally unchanged. Nasdaq's current listing rules include phase-in schedules for: Companies listing in connection with an initial public offering,<sup>63</sup> Companies emerging from bankruptcy<sup>64</sup> and Companies ceasing to be Controlled Companies.<sup>65</sup> Since each of these categories of Company did not previously have a compensation committee, each is allowed to phase in compliance with the compensation committee composition requirement as follows: (1) one independent member at the time of listing; (2) a majority of independent members within 90 days of listing; and (3) all independent members within one year of listing. Nasdaq proposes that these phase-in schedules remain unchanged under its revised listing rules, except to clarify that a Company may phase in compliance with the minimum size requirement and

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<sup>62</sup> This proposal adopts the requirements of Rule 10C-1(b)(1)(iii)(A)(4), which provides an exemption from the independence requirements of Rule 10C-1 for a "foreign private issuer that discloses in its annual report the reasons that the foreign private issuer does not have an independent compensation committee."

<sup>63</sup> See Nasdaq Listing Rule 5615(b)(1).

<sup>64</sup> See Nasdaq Listing Rule 5615(b)(2).

<sup>65</sup> See Nasdaq Listing Rule 5615(c)(3).

the additional eligibility requirements adopted pursuant to Rule 10C-1, as well as the requirement for compensation committee members to be Independent Directors.<sup>66</sup>

In addition, Nasdaq proposes no changes to the phase-in schedule in its current listing rules for Companies transferring from other markets.<sup>67</sup> Companies transferring from other markets with a substantially similar requirement shall be afforded the balance of any grace period afforded by the other market. Companies transferring from other listed markets that do not have a substantially similar requirement shall be afforded one year from the date of listing on Nasdaq to comply with the compensation committee composition requirements.

None of the aforementioned phase-in schedules apply to the requirement to adopt a formal written compensation committee charter including the content specified in Nasdaq Listing Rule 5605(d)(1)(A)-(D).<sup>68</sup>

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<sup>66</sup> To provide an illustration of how the compensation committee composition requirement will interact with the minimum size requirement, consider a Company that at the time of listing has a compensation committee consisting of two members, both of whom are Independent Directors, but one of whom accepts compensatory fees of \$50,000 annually from the Company pursuant to a consulting agreement. Although only one of these directors is fully eligible to serve on the compensation committee, the committee meets the requirements of Nasdaq's phase-in schedule because it has one fully eligible member at the time of listing. By the 90<sup>th</sup> day from listing, the committee must have a majority of fully eligible members, so the Company could: (i) remove the ineligible member and temporarily have a committee of one fully eligible member; (ii) replace the ineligible member with a fully eligible member so that the committee consists of two members, all of whom are fully eligible; or (iii) add a second fully eligible member so that the committee consists of three members, a majority of whom are fully eligible. By one year from listing, the Company's compensation committee must consist of at least two members, and all members must be fully eligible under Nasdaq's compensation committee composition requirement.

<sup>67</sup> See Nasdaq Listing Rule 5615(b)(3).

<sup>68</sup> As discussed below under "Smaller Reporting Companies," Nasdaq is proposing a new phase-in schedule for a Company ceasing to be a Smaller Reporting Company. Nasdaq proposes to allow such a Company 30 days to certify to

### Smaller Reporting Companies

While Rule 10C-1 exempts Smaller Reporting Companies from all of its requirements, Nasdaq's current listing rules do not include any such exemptions.<sup>69</sup> Consistent with the exemption in Rule 10C-1, however, Nasdaq proposes not to require Smaller Reporting Companies to adhere to the new requirements relating to compensatory fees and affiliation, which Nasdaq is proposing in response to Rule 10C-1, or to incorporate into their formal written compensation committee charter or board resolution that specifies the committee's responsibilities and authority the language in Rule 10C-1 regarding compensation advisers. This approach will minimize new costs imposed on Smaller Reporting Companies and allow them some flexibility not allowed for larger Companies.

However, as discussed above, Nasdaq proposes to eliminate the Alternative in its current listing rules that allows compensation decisions to be made by a majority of the Independent Directors rather than by a committee composed entirely of Independent Directors. Nasdaq proposes to eliminate the Alternative for Smaller Reporting Companies, just like all other Nasdaq-listed Companies. As a result, Smaller Reporting Companies would be required to have a compensation committee comprised of at least two Independent Directors as defined under Nasdaq's existing listing rules.

In addition, Nasdaq proposes that Smaller Reporting Companies must adopt a formal written compensation committee charter or board resolution that specifies the

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Nasdaq that it has adopted a formal written compensation committee charter including the content specified in Nasdaq Listing Rule 5605(d)(1)(A)-(D). See footnote 71, infra.

<sup>69</sup> See 17 CFR 240.10C-1(b)(5)(ii).

committee's responsibilities and authority. Unlike other Companies, Smaller Reporting Companies may include this content in a board resolution, rather than a compensation committee charter, and Smaller Reporting Companies are not required to review and reassess the adequacy of the charter or board resolution on an annual basis. The charter or board resolution must specify the same content as other Companies, except Smaller Reporting Companies are not required to specify the specific compensation responsibilities and authority set forth in proposed Nasdaq Listing Rule 5605(d)(3) 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.<sup>70</sup>

Nasdaq also proposes to apply the same phase-in schedule to a Company ceasing to be a Smaller Reporting Company that applies to a Company listing in conjunction with its initial public offering. Since a Smaller Reporting Company is required to have a compensation committee comprised of at least two Independent Directors, a Company that has ceased to be a Smaller Reporting Company may use the phase-in schedule for the additional eligibility requirements relating to compensatory fees and affiliation, but not for the minimum size requirement or the requirement that the committee consist only of Independent Directors. This phase-in schedule will start to run on the due date of the SEC filing in which the Company is required to report that it is an issuer other than a

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<sup>70</sup> Nasdaq notes that Smaller Reporting Companies remain subject to the disclosure requirements of Item 407(e)(3)(iv) of Regulation S-K, which were adopted at the same time as Rule 10C-1. See the Adopting Release.

Smaller Reporting Company.<sup>71</sup> During the phase-in schedule, a Smaller Reporting Company must continue to comply with the requirement to have a compensation committee comprised of at least two Independent Directors as defined under Nasdaq's existing listing rules.

Effective Dates/Transition

Nasdaq proposes that Rule 5605(d)(3), relating to compensation committee responsibilities and authority, shall be effective immediately. Specifically, this proposed rule states that a compensation committee must have the specific compensation committee responsibilities and authority necessary to comply with Rule 10C-1(b)(2), (3) and (4)(i)-(vi) under the Act 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. 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. Companies should consider under state corporate law whether to grant these specific responsibilities and authority through a charter, resolution or other board action; however, Nasdaq proposes to require only that compensation committees

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<sup>71</sup> Within 30 days after the start of its phase-in schedule, a Company that has ceased to be a Smaller Reporting Company must certify to Nasdaq that: (i) it has complied with the requirement in Nasdaq Listing Rule 5605(d)(1) to have a compensation committee charter including the content specified in Nasdaq Listing Rule 5605(d)(1)(A)-(D); and (ii) it has, or will within the applicable phase-in schedule, comply with the requirement in Nasdaq Listing Rule 5605(d)(2) regarding compensation committee composition.

immediately have such responsibilities and authority. While Nasdaq proposes that Companies must eventually have a written compensation committee charter that includes, among others, these responsibilities and authority, Companies may implement such a charter on the schedule discussed below.

In order to allow Companies to make necessary adjustments to their boards and committees in the course of their regular annual meeting schedules, Nasdaq proposes that Companies must comply with the remaining provisions of the amended listing rules on compensation committees by the earlier of: (1) their second annual meeting held after the date of approval of Nasdaq's amended listing rules; or (2) December 31, 2014. This transition period is similar to the transition period used when Nasdaq implemented similar requirements for audit committees in 2003.<sup>72</sup>

A Company must certify to Nasdaq, no later than 30 days after the implementation deadline applicable to it, that it has complied with the amended listing rules on compensation committees. Nasdaq will provide Companies with a form for this certification.

During the transition period, Companies that are not yet required to comply with the amended listing rules on compensation committees must continue to comply with Nasdaq's existing listing rules, which have been redesignated as Listing Rule 5605A(d) and IM-5605A-6 in Nasdaq's proposal.

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<sup>72</sup> See Securities Exchange Act Release No. 48745 (November 4, 2003), 68 FR 64154 (November 12, 2003) (SR-NASD-2002-141).



Conforming Changes and Correction of Typographical Errors

Finally, Nasdaq proposes to make minor conforming changes to its requirements relating to audit and nominations committees. Nasdaq also proposes to correct certain typographical errors in its corporate governance requirements as set forth in Exhibit 5.

b. Statutory Basis

Nasdaq believes that the proposed rule change is consistent with the provisions of Section 6 of the Exchange Act,<sup>73</sup> in general, and with Section 6(b)(5) of the Exchange Act,<sup>74</sup> in particular. Section 6(b)(5) requires, among other things, that a national securities exchange's rules must be designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, to remove impediments to and perfect the mechanism of a free and open market and a national market system and, in general, to protect investors and the public interest. Section 6(b)(5) also requires that a national securities exchange's rules not be designed to permit unfair discrimination between customers, issuers, brokers or dealers.

As required by the Dodd-Frank Act and Rule 10C-1, Nasdaq is proposing amendments to its listing rules relating to the independence of compensation committees and their advisers. Nasdaq reviewed its existing compensation-relating listing rules, in combination with the requirements of Rule 10C-1, to develop a set of proposed compensation-related listing rules. These proposals generally fall into three categories: proposed rule amendments to comply with Rule 10C-1; proposals to continue certain rules relatively unchanged; and proposed rule amendments not required by Rule 10C-1. Nasdaq believes that collectively, these proposals protect investors and the public interest

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<sup>73</sup> 15 U.S.C. 78f.

<sup>74</sup> 15 U.S.C. 78f(b)(5).

by requiring Companies, with certain exemptions, to have a compensation committee meeting certain requirements relating to composition, responsibilities and authority.

More specifically, Nasdaq's proposed amendments to its listing rules in order to comply with Rule 10C-1 set forth: additional eligibility requirements for compensation committee members relating to compensatory fees and affiliation; an opportunity to cure defects in compensation committee composition; a requirement that compensation committees have the specific responsibilities and authority necessary to comply with Rule 10C-1(b)(2), (3) and (4)(i)-(vi) under the Exchange Act; and exemptions for limited partnerships, management investment companies, Controlled Companies, foreign private issuers that provide certain required disclosures, and Smaller Reporting Companies. Nasdaq believes that its proposals fairly balance the goal of protecting the investing public by ensuring effective deliberation over executive compensation with the goal of avoiding the imposition of undue costs on Companies.

Nasdaq's proposals to continue relatively unchanged some of its existing exemptions to the compensation-related listing rules for certain categories of Companies takes into account the unique characteristics of these Companies.<sup>75</sup> As a result, Nasdaq does not believe that continuing these exemptions will discriminate unfairly among issuers, consistent with Section 6(b)(5) of the Exchange Act.<sup>76</sup>

The proposed rule amendments not required by Rule 10C-1 require that: Companies must have a standing compensation committee; the committee must consist of a minimum of two members; the committee must have a formal written charter (or board resolution, in the case of Smaller Reporting Companies) that specifies the committee's

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<sup>75</sup> See footnotes 56-61, supra.

<sup>76</sup> 15 U.S.C. 78f(b)(5).

responsibilities and authority; and Smaller Reporting Companies must continue to comply with certain of Nasdaq's compensation-related listing rules. As discussed in the "Purpose" section, Nasdaq believes that these new requirements will facilitate effective oversight of executive compensation and promote accountability to investors for executive compensation decisions. With regard to Smaller Reporting Companies, Nasdaq notes that these Companies continue to be subject to the same requirements as all other Companies, except the new requirements that Nasdaq is proposing under Rule 10C-1 relating to compensatory fees, affiliation and the specific compensation committee responsibilities and authority set forth in proposed Nasdaq Listing Rule 5605(d)(3). Nasdaq believes that this hybrid approach does not discriminate unfairly between issuers because it recognizes the fact that the "executive compensation arrangements of [Smaller Reporting Companies] generally are so much less complex than those of other public companies that they do not warrant the more extensive disclosure requirements imposed on companies that are not [Smaller Reporting Companies] and related regulatory burdens that could be disproportionate for [Smaller Reporting Companies]."<sup>77</sup> In addition, Nasdaq notes that the Commission exempted Smaller Reporting Companies from Rule 10C-1.<sup>78</sup> As a result, this distinction does not discriminate unfairly among issuers.

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<sup>77</sup> See the Adopting Release, at 38438 (quoting Securities Exchange Act Release No. 54302A (August 29, 2006), 71 FR 53158, 53192 (September 8, 2006)).

<sup>78</sup> See 17 CFR 240.10C-1(b)(5)(ii).

4. Self-Regulatory Organization's Statement on Burden on Competition

Nasdaq does not believe that the proposed rule change will result in any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Exchange Act, as amended.

5. Self-Regulatory Organization's Statement on Comments on the Proposed Rule Change Received from Members, Participants, or Others

Nasdaq did not solicit comments on the proposed rule change. Nasdaq received two written comments, which are attached as Exhibit 2.

The first commenter recommended that Nasdaq should require Companies to disclose: (i) how they are complying with the requirement to consider the independence factors enumerated in Rule 10C-1; and (ii) the nature of any conflict of interest arising from the engagement of legal counsel by a compensation committee. Nasdaq considered these recommendations, but it preferred to defer to the judgment of the Commission with respect to the appropriate disclosure framework under Rule 10C-1. Nasdaq therefore decided not to propose any new disclosure requirements for Companies, other than those that are required by Rule 10C-1.<sup>79</sup>

The second commenter proffered four recommendations. First, this commenter recommended that Nasdaq include director fees within the list of relevant factors that must be considered when assessing the independence of compensation committee members. Nasdaq does not believe that the intent of the Dodd-Frank Act or Rule 10C-1 was to limit independence based on director compensation, and therefore, Nasdaq

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<sup>79</sup> Specifically, as required by Rule 10C-1(b)(1)(iii)(A)(4), Nasdaq proposes to require a Foreign Private Issuer that follows a home country practice in lieu of the requirement to have an independent compensation committee to disclose the reasons why it does not have such a committee.

proposes to continue to exempt board fees from its prohibition on payment of compensatory fees to a compensation committee member. Second, this commenter recommended that Nasdaq include in the requirements for compensation committee independence a factor relating to business or personal relationships between directors and officers. As discussed in the “Purpose” section above, Nasdaq reviewed its current and proposed listing rules and concluded that these rules are sufficient to ensure the independence of compensation committee members. Therefore, Nasdaq determined not to propose further independence requirements, other than those discussed above. Third, this commenter recommended that Nasdaq expand the additional factors for compensation committee eligibility to cover all independent directors, not just those serving on the compensation committee. While Nasdaq heavily weighed the commenter’s concern that multiple definitions of independence add to the complexity of board membership, Nasdaq believed that the intent of the Dodd-Frank Act and Rule 10C-1 was to address the independence of compensation committee members, as well as their advisers, specifically. Nasdaq concluded therefore that it is inappropriate to expand the additional requirements proposed herein to cover all independent directors. Finally, this commenter recommended that Nasdaq clarify that, while the factors must be considered in their totality, a single factor can result in a loss of director independence. Nasdaq confirms that a director cannot be deemed independent if he or she fails any one of the bright-line prohibitions in Nasdaq Listing Rule 5605(a)(2).

6. Extension of Time Period for Commission Action

Nasdaq does not consent at this time to an extension of the time period for Commission action specified in Section 19(b)(2) of the Exchange Act.

7. Basis for Summary Effectiveness Pursuant to Section 19(b)(3) or for Accelerated Effectiveness Pursuant to Section 19(b)(2)

Not applicable.

8. Proposed Rule Change Based on Rules of Another Self-Regulatory Organization or of the Commission

As discussed above, the proposed rule change is based, in part, on Rule 10C-1.<sup>80</sup>

9. Exhibits

1. Completed notice of proposed rule change for publication in the Federal Register.

2. Comments received on the proposed rule change.

5. Text of proposed rule change.

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<sup>80</sup> See 17 CFR 240.10C-1.

**EXHIBIT 1**

## SECURITIES AND EXCHANGE COMMISSION

(Release No. 34- ; File No. SR-NASDAQ-2012-109)

September \_\_, 2012

Self-Regulatory Organizations; The NASDAQ Stock Market LLC; Notice of Filing of Proposed Rule Change to Modify the Listing Rules for Compensation Committees To Comply with Rule 10C-1 under the Exchange Act and Make Other Related Changes

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (“Exchange Act”),<sup>1</sup> and Rule 19b-4 thereunder,<sup>2</sup> notice is hereby given that on September 25, 2012, The NASDAQ Stock Market LLC (“Nasdaq”) filed with the Securities and Exchange Commission (“Commission”) the proposed rule change as described in Items I, II, and III below, which Items have been substantially prepared by Nasdaq. The Commission is publishing this notice to solicit comments on the proposed rule change from interested persons.

I. Self-Regulatory Organization’s Statement of the Terms of the Substance of the Proposed Rule Change

Nasdaq proposes to modify the listing rules for compensation committees to comply with Rule 10C-1 under the Exchange Act and make other related changes. The text of the proposed rule change is available on Nasdaq’s Website at <http://nasdaq.cchwallstreet.com>, at Nasdaq’s principal office, and at the Commission’s Public Reference Room.

Nasdaq will implement the proposed rule upon approval. Proposed Nasdaq Listing Rule 5605(d)(3), which requires compensation committees to have the specific responsibilities and authority necessary to comply with Rule 10C-1(b)(2), (3) and (4)(i)-

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<sup>1</sup> 15 U.S.C. 78s(b)(1).

<sup>2</sup> 17 CFR 240.19b-4.

(vi) under the Exchange Act, shall be effective immediately. 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.

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.

II. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

In its filing with the Commission, Nasdaq included statements concerning the purpose of and basis for the proposed rule change and discussed any comments it received on the proposed rule change. The text of these statements may be examined at the places specified in Item IV below. Nasdaq has prepared summaries, set forth in Sections A, B, and C below, of the most significant aspects of such statements.

A. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

1. Purpose

Section 952 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the "Dodd-Frank Act")<sup>3</sup> added Section 10C to the Exchange Act.<sup>4</sup> Section 10C required the Commission to direct the national securities exchanges, including Nasdaq,

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<sup>3</sup> Pub. L. No. 111-203, 124 Stat. 1376 (2010).

<sup>4</sup> 15 U.S.C. 78j-3.



and national securities associations to prohibit the listing of any equity security of an issuer, with certain exemptions, that does not comply with Section 10C's requirements relating to compensation committees and advisers. To effect this requirement, the Commission has adopted Rule 10C-1 under the Exchange Act, which became effective on July 27, 2012. Rule 10C-1 requires each national securities exchange and national securities association to provide to the Commission, no later than September 25, 2012, proposed rules or rule amendments that comply with the requirements of Rule 10C-1.<sup>5</sup>

Rule 10C-1 generally requires that:

- each member of the compensation committee of a listed issuer must be an independent member of the board of directors;
- in determining independence requirements for compensation committee members, exchanges must consider relevant factors, including, but not limited to:
  - the source of compensation of a member, including any consulting, advisory or other compensatory fee paid by the issuer to such member; and
  - whether the member is affiliated with the issuer, a subsidiary of the issuer or an affiliate of a subsidiary of the issuer;
- the compensation committee must have the authority to retain or obtain the advice of a compensation consultant, independent legal counsel or other compensation adviser;

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<sup>5</sup> See 17 CFR 240.10C-1(a)(4)(i).

- the listed issuer must provide for appropriate funding, as determined by the compensation committee, for payment of reasonable compensation to such compensation advisers;
- the compensation committee may select such compensation advisers only after taking into consideration six independence factors that are enumerated in Rule 10C-1, as well as any other factors identified by an exchange; and
- certain categories of issuers, including, but not limited to, controlled companies and smaller reporting companies, are generally exempt from all of Rule 10C-1, while other categories of issuers, including, but not limited to, foreign private issuers that provide certain disclosures, are specifically exempt from the requirement to have a fully independent compensation committee.

#### General Overview of Nasdaq's Proposals

Nasdaq is proposing to modify its compensation-related listing rules, as required by Rule 10C-1. Generally, Nasdaq's proposals provide that:

- Companies<sup>6</sup> must have a compensation committee consisting of at least two members, each of whom must be an Independent Director<sup>7</sup> as defined under Nasdaq's current listing rules;

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<sup>6</sup> "Company" means "the issuer of a security listed or applying to list on Nasdaq." Nasdaq Listing Rule 5005(a)(6).

<sup>7</sup> For a discussion of the definition of the term "Independent Director," see the section entitled "Compensation Committee Composition – General Independence Definition" below. Notwithstanding any of the proposed changes, and consistent with Nasdaq's existing listing rules, a Company's board has the responsibility to make an affirmative determination that no Independent Director has a relationship

- 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 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;

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

- 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<sup>8</sup> 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.

Rule 10C-1 requires Nasdaq to include in its submission: (i) a review of whether and how its existing or proposed listing rules satisfy the requirements of Rule 10C-1; (ii) a discussion of the consideration of factors relevant to compensation committee independence conducted by Nasdaq; and (iii) the definition of independence applicable to compensation committee members that Nasdaq proposes to adopt or retain in light of such review.<sup>9</sup> Nasdaq's proposals and its underlying analysis are discussed in depth below.

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<sup>8</sup> Smaller Reporting Company is defined in Rule 12b-2 under the Exchange Act.

<sup>9</sup> See 17 CFR 240.10C-1(a)(4)(i).

Requirement to Have a Compensation Committee

Nasdaq's current listing rules require that compensation of the chief executive officer and all other Executive Officers<sup>10</sup> of a Company must be determined, or recommended to the board for determination, either by: (i) a compensation committee comprised solely of Independent Directors; or (ii) Independent Directors constituting a majority of the board's Independent Directors in a vote in which only Independent Directors participate (the "Alternative").<sup>11</sup>

Although it was not required to do so by Rule 10C-1,<sup>12</sup> Nasdaq considered whether the Alternative remains appropriate given the heightened importance of compensation decisions in today's corporate governance environment. Since responsibility for executive compensation decisions is one of the most important responsibilities entrusted to a board of directors, Nasdaq believes that there are benefits from a board having a standing committee dedicated solely to oversight of executive compensation. Specifically, directors on a standing compensation committee may develop expertise in a Company's executive compensation program in the same way that directors on a standing audit committee develop expertise in a Company's accounting and financial reporting processes. In addition, a formal committee structure may help promote accountability to stockholders for executive compensation decisions.

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<sup>10</sup> "Executive Officer" is defined as an officer "covered in Rule 16a-1(f) under the [Exchange] Act." Nasdaq Listing Rule 5605(a)(1).

<sup>11</sup> See Nasdaq Listing Rules 5605(d)(1) and (2).

<sup>12</sup> See Securities Exchange Act Release No. 67220 (June 20, 2012), 77 FR 38422, 38425 (June 27, 2012) (the "Adopting Release") (stating that "[t]he final rule will not require a listed issuer to have a compensation committee or a committee that performs functions typically assigned to a compensation committee.")

Nasdaq also considered whether eliminating the Alternative would pose an undue hardship on Nasdaq-listed Companies. Only a small number of Companies rely on the Alternative,<sup>13</sup> and since the Alternative requires certain executive compensation decisions to be determined, or recommended to the board for determination, by a majority of the board's Independent Directors, these Companies already have some directors who focus on executive compensation. In addition, Nasdaq would allow a transition period for these Companies to implement a standing compensation committee. As a result, Nasdaq does not believe that eliminating the Alternative would be unduly burdensome to Companies.

As a result, Nasdaq proposes to eliminate the Alternative and require Nasdaq-listed Companies to have a standing compensation committee with the responsibility for determining, or recommending to the full board for determination, the compensation of the chief executive officer and all other Executive Officers of the Company.

#### Compensation Committee Size

Nasdaq's current listing rules do not impose size requirements on any board committees, other than the audit committee, which must consist of at least three members.<sup>14</sup> As a result, it is possible to have a compensation committee comprised of only one member under Nasdaq's current listing rules.

Although it was not required to do so by Rule 10C-1, Nasdaq considered whether it is appropriate to impose a minimum size requirement on a compensation committee. Given the importance of compensation decisions to stockholders, Nasdaq believes that it is appropriate to have more than one director responsible for these decisions and that

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<sup>13</sup> As of June 30, 2012, only 25 of 2,636 Nasdaq-listed Companies relied on the Alternative in lieu of having a standing compensation committee.

<sup>14</sup> See Nasdaq Listing Rule 5605(c)(2)(A).

therefore, a compensation committee should consist of at least two members. Nasdaq then considered whether to require compensation committees to adhere to the same size requirement as audit committees and have a minimum of three members. However, Nasdaq was concerned that it might be difficult for Companies, especially smaller Companies, to comply with a requirement to have a three-member compensation committee, in addition to a three-member audit committee.

Nasdaq also considered whether imposing a minimum size requirement on a compensation committee would be unduly burdensome to Nasdaq-listed Companies, especially in combination with the proposal to eliminate the Alternative, as discussed above. Since only a small number of Companies currently have a compensation committee of one member and Nasdaq would allow a transition period to add an additional member, Nasdaq does not believe that requiring a compensation committee to consist of at least two members would be an undue hardship for Nasdaq-listed Companies.<sup>15</sup>

As a result, Nasdaq proposes to require a compensation committee of a Company to consist of at least two members of the board of directors.

#### Compensation Committee Composition – General Independence Definition

Nasdaq's current listing rules require a compensation committee to be comprised solely of Independent Directors, as defined in Nasdaq Listing Rule 5605(a)(2).<sup>16</sup> This definition includes a two-part test for independence. First, there are certain categories of directors who cannot be considered independent, including:

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<sup>15</sup> As of June 30, 2012, only 26 of 2,636 Nasdaq-listed Companies had a compensation committee of only one member.

<sup>16</sup> See Nasdaq Listing Rules 5605(d)(1) and (2).

- a director who is an Executive Officer or employee of the Company;<sup>17</sup>
- a director who is, or at any time during the past three years was, employed by the Company;<sup>18</sup>
- a director who accepted or who has a Family Member<sup>19</sup> who accepted any compensation from the Company in excess of \$120,000 during any period of twelve consecutive months within the three years preceding the determination of independence;<sup>20</sup>
- a director who is a Family Member of an individual who is, or at any time during the past three years was, employed by the Company as an Executive Officer;<sup>21</sup>
- a director who is, or has a Family Member who is, a partner in, or a controlling Shareholder<sup>22</sup> or an Executive Officer of, any organization to

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<sup>17</sup> See Nasdaq Listing Rule 5605(a)(2). The rule's reference to the term "Company" includes any parent or subsidiary of the Company. The term "parent or subsidiary" is intended to cover entities the Company controls and consolidates with the Company's financial statements as filed with the Commission (but not if the Company reflects such entity solely as an investment in its financial statements). See IM-5605.

<sup>18</sup> See Nasdaq Listing Rule 5605(a)(2)(A).

<sup>19</sup> "Family Member" is defined as "a person's spouse, parents, children and siblings, whether by blood, marriage or adoption, or anyone residing in such person's home." Nasdaq Listing Rule 5605(a)(2).

<sup>20</sup> See Nasdaq Listing Rule 5605(a)(2)(B). This prohibition includes exceptions for: (i) compensation for board or board committee service; (ii) compensation paid to a Family Member who is an employee (other than an Executive Officer) of the Company; or (iii) benefits under a tax-qualified retirement plan, or non-discretionary compensation.

<sup>21</sup> See Nasdaq Listing Rule 5605(a)(2)(C).

<sup>22</sup> "Shareholder" is defined as "a record or beneficial owner of a security listed or applying to list. For purposes of [Nasdaq's Listing Rules], the term 'Shareholder'



which the Company made, or from which the Company received, payments for property or services in the current or any of the past three fiscal years that exceed 5% of the recipient's consolidated gross revenues for that year, or \$200,000, whichever is more;<sup>23</sup>

- a director of the Company who is, or has a Family Member who is, employed as an Executive Officer of another entity where at any time during the past three years any of the Executive Officers of the Company serve on the compensation committee of such other entity;<sup>24</sup> or
- a director who is, or has a Family Member who is, a current partner of the Company's outside auditor, or was a partner or employee of the Company's outside auditor who worked on the Company's audit at any time during any of the past three years.<sup>25</sup>

Second, a Company's board of directors must make an affirmative determination that each Independent Director has no relationship that, in the opinion of

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includes, for example, a limited partner, the owner of a depository receipt, or unit." Nasdaq Listing Rule 5005(a)(38).

<sup>23</sup> See Nasdaq Listing Rule 5605(a)(2)(D). This prohibition includes exceptions for payments: (i) arising solely from investments in the Company's securities; or (ii) under non-discretionary charitable contribution matching programs.

<sup>24</sup> See Nasdaq Listing Rule 5605(a)(2)(E).

<sup>25</sup> See Nasdaq Listing Rule 5605(a)(2)(F). In the case of an investment company, in lieu of the prohibitions in Nasdaq Listing Rule 5605(a)(2)(A) – (F), a director cannot be considered independent if he or she is an "interested person" of the Company as defined in Section 2(a)(19) of the Investment Company Act of 1940, other than in his or her capacity as a member of the board of directors or any board committee.

the board, would interfere with the exercise of independent judgment in carrying out the responsibilities of a director.<sup>26</sup>

Nasdaq proposes to continue unchanged its existing requirement that a compensation committee be comprised solely of Independent Directors, as defined in Nasdaq Listing Rule 5605(a)(2).

Compensation Committee Composition – Compensatory Fees

Rule 10C-1 requires that in determining the independence requirements for compensation committee members, Nasdaq must consider relevant factors, including, but not limited to, the source of compensation of a member, including any consulting, advisory or other compensatory fee paid by the issuer to the member.<sup>27</sup> In considering this particular factor, Nasdaq reviewed its current listing rules relating to compensatory fees. As outlined above, Nasdaq's current listing rules require compensation committee members to be Independent Directors. Independent Director is defined to exclude any director who: (i) accepted any compensation from the Company in excess of \$120,000 during any period of twelve consecutive months within the prior three years; or (ii) is a partner in, or a controlling Shareholder or an Executive Officer of, any organization to which the Company made, or from which the Company received, payments for property or services in the current or any of the past three fiscal years that exceed 5% of the recipient's consolidated gross revenues for that year, or \$200,000, whichever is more.<sup>28</sup> As a result, directors who receive compensatory fees from a Company below these thresholds may serve on a compensation committee under Nasdaq's current listing rules.

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<sup>26</sup> See Nasdaq Listing Rule 5605(a)(2) and IM-5605.

<sup>27</sup> See 17 CFR 240.10C-1(b)(1)(ii)(A).

<sup>28</sup> See Nasdaq Listing Rules 5605(a)(2)(B) and (D).

This is in contrast to Nasdaq's current listing rules relating to audit committees, which require audit committee members to meet the criteria for independence set forth in Rule 10A-3(b)(1) under the Exchange Act, subject to certain exemptions.<sup>29</sup> Rule 10A-3(b)(1) prohibits an audit committee member from accepting directly or indirectly any consulting, advisory or other compensatory fee from an issuer or any subsidiary, with certain exemptions.

After reviewing its current listing rules, Nasdaq concluded that there is no compelling justification to have different independence standards for audit and compensation committee members with respect to the acceptance of compensatory fees from a Company. Accordingly, Nasdaq proposes to adopt the same standard for compensation committee members that applies to audit committee members under Rule 10A-3 under the Exchange Act with respect to compensatory fees. Specifically, Nasdaq's proposal prohibits a compensation committee member from accepting directly or indirectly any consulting, advisory or other compensatory fee from an issuer or any subsidiary. As in Rule 10A-3, compensatory fees shall not include: (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).<sup>30</sup> Also similar to Rule 10A-3, the proposed requirement applicable to compensation committee members

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<sup>29</sup> See Nasdaq Listing Rule 5605(c)(2)(A)(ii).

<sup>30</sup> See 17 CFR 240.10A-3(b)(1).

will not include a “look-back” period.<sup>31</sup> Accordingly, the prohibition on the receipt of any consulting, advisory or other compensatory fee by a compensation committee member begins with the member’s term of service on the compensation committee.<sup>32</sup>

#### Compensation Committee Composition – Affiliation

Rule 10C-1 requires that in determining the independence requirements for compensation committee members, Nasdaq also must consider whether a member is affiliated with the issuer, a subsidiary of the issuer or an affiliate of a subsidiary of the issuer.<sup>33</sup> In considering this particular factor, Nasdaq reviewed its current listing rules relating to affiliation. As outlined above, Nasdaq’s current listing rules require compensation committee members to be Independent Directors. The definition of the term “Independent Director” does not refer to affiliation, although the definition does exclude certain individuals who may be considered affiliates from being an Independent Director. For example, any director who is an Executive Officer of the Company cannot be considered an Independent Director.<sup>34</sup> Significantly, the Interpretive Material to Nasdaq’s definition of Independent Director states that “[b]ecause Nasdaq does not

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<sup>31</sup> See Securities Exchange Act Release No. 47654 (April 9, 2003), 68 FR 18788, 18792 (April 16, 2003) (stating that “[t]he final rule, like [the] proposal, applies the prohibitions only to current relationships with the audit committee member and related persons. They do not extend to a ‘look back’ period before appointment to the audit committee....”)

<sup>32</sup> Nasdaq notes, however, that as discussed above, compensation committee members must be Independent Directors as defined in Nasdaq Listing Rule 5605(a)(2). Each of the bright-line tests in this definition includes a three-year “lookback” period. See Nasdaq Listing Rule 5605(a)(2).

<sup>33</sup> See 17 CFR 240.10C-1(b)(1)(ii)(B).

<sup>34</sup> See Nasdaq Listing Rule 5605(a)(2).

believe that ownership of Company stock by itself would preclude a board finding of independence, it is not included in the aforementioned objective factors.”<sup>35</sup>

Beyond the definition of Independent Director, Nasdaq’s current listing rules relating to audit committees require audit committee members to meet the criteria for independence set forth in Rule 10A-3(b)(1) under the Exchange Act, subject to certain exemptions.<sup>36</sup> Rule 10A-3(b)(1) prohibits an audit committee member from being an affiliated person of the issuer or any subsidiary thereof. The term “affiliate” means “a person that directly, or indirectly through one or more intermediaries, controls, or is controlled by, or is under common control with, the person specified.”<sup>37</sup> However, Rule 10A-3 includes a safe harbor for a person that is not: (i) the beneficial owner, directly or indirectly, of more than 10% of any class of voting equity securities of the specified person; and (ii) an executive officer of a specified person.<sup>38</sup>

After reviewing its current listing rules, Nasdaq considered whether to propose that compensation committee members must meet the same standard applicable to audit committee members under Rule 10A-3 under the Exchange Act with respect to affiliation, similar to its proposal with respect to compensatory fees. However, Nasdaq concluded that such a blanket prohibition would be inappropriate for compensation committees. In fact, Nasdaq believes that it may be appropriate for certain affiliates, such as representatives of significant stockholders, to serve on compensation committees since

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<sup>35</sup> IM-5605.

<sup>36</sup> See Nasdaq Listing Rule 5605(c)(2)(A)(ii).

<sup>37</sup> See 17 CFR 240.10A-3(e)(1).

<sup>38</sup> Id.

their interests are likely aligned with those of other stockholders in seeking an appropriate executive compensation program.

As a result, Nasdaq proposes that Companies' boards of directors should consider affiliation in making an eligibility determination for compensation committee members, but it does not propose bright-line rules around this factor. In making this eligibility determination, a Company's board specifically 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. In performing this analysis, a board of directors is not required to apply a "look-back" period, and is therefore required to consider affiliation only with respect to relationships that occur during an individual's term of service as a compensation committee member.

A board may conclude that it is appropriate for a director who is an affiliate to serve on the compensation committee. While this differs from the requirement applicable to audit committee members, Nasdaq could identify no compelling policy justification for precluding all affiliates, such as owners of a Company, even those with very large stakes, from serving on the compensation committee.

#### Compensation Committee Composition – Other

Rule 10C-1 permits Nasdaq to consider other relevant factors in determining the independence requirements for compensation committee members.<sup>39</sup> After reviewing its current and proposed listing rules, Nasdaq concluded that these rules are sufficient to

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<sup>39</sup> See 17 CFR 240.10C-1(b)(1)(ii).

ensure the independence of compensation committee members. Therefore, Nasdaq determined not to propose further independence requirements.

Exceptional and Limited Circumstances Exception

With minor edits, Nasdaq proposes to retain its existing exception that allows a Company to have a non-Independent Director serve on the compensation committee under exceptional and limited circumstances.<sup>40</sup> Under this exception, if a compensation committee consists of at least three members, one director who is not an Independent Director and is not currently an Executive Officer or employee or a Family Member of an Executive Officer, may be appointed to the compensation committee if the board, under exceptional and limited circumstances, determines that such individual's membership on the committee is required by the best interests of the Company and its Shareholders. A Company that relies on this exception must disclose either on or through the Company's website or in the proxy statement for the next annual meeting subsequent to such determination (or, if the Company does not file a proxy, in its Form 10-K or 20-F), the nature of the relationship and the reasons for the determination. In addition, the Company must provide any disclosure required by Instruction 1 to Item 407(a) of Regulation S-K regarding its reliance on this exception. A member appointed under this exception may not serve longer than two years.

In addition to the existing exception for compensation committees, Nasdaq's current listing rules include similar exceptions for audit and nominations committees.<sup>41</sup>

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<sup>40</sup> See Nasdaq Listing Rule 5605(d)(3).

<sup>41</sup> See Nasdaq Listing Rules 5605(c)(2)(B) and 5605(e)(3). Nasdaq recently amended the exceptions for all three committees to allow a Company to rely on the exception for a non-Independent Director who is a Family Member of a non-executive employee of the Company. See Securities Exchange Act Release No.

While these exceptions are used infrequently by Nasdaq-listed Companies,<sup>42</sup> Nasdaq believes they are an important means to allow Companies flexibility as to board and committee membership and composition in unusual circumstances, which may be particularly important for smaller Companies.

Nasdaq would allow a Company to avail itself of the exception even for a director who fails the new requirements adopted pursuant to Rule 10C-1.

#### Cure Period

Consistent with Rule 10C-1, Nasdaq's proposal provides Companies with an opportunity to cure defects in the composition of compensation committees.<sup>43</sup> The proposed cure period is copied from the cure period in Nasdaq's current listing rules for noncompliance with the requirement to have a majority independent board.<sup>44</sup>

Under Nasdaq's proposal, if a Company fails to comply with the compensation committee composition requirements due to one vacancy, or one compensation committee member ceases to be independent due to circumstances beyond the member's reasonable control, the Company shall regain compliance by the earlier of the next annual shareholders meeting or one year from the occurrence of the event that caused the noncompliance. However, if the annual shareholders meeting occurs no later than 180 days following the event that caused the noncompliance, the Company shall instead have

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67468 (July 19, 2012), 77 FR 43618 (July 25, 2012) (SR-NASDAQ-2012-062). Nasdaq proposes to retain this aspect of the exception for compensation committees, as well as audit and nominations committees.

<sup>42</sup> On June 30, 2012, ten of 2,636 Nasdaq-listed Companies were using one of these exceptions: six Companies for the audit committee and four Companies for the nominations committee. No Companies were using this exception for the compensation committee.

<sup>43</sup> See 17 CFR 240.10C-1(a)(3).

<sup>44</sup> See Nasdaq Listing Rule 5605(b)(1)(A).



180 days from such event to regain compliance. This provides a Company at least 180 days to cure noncompliance and would typically allow a Company to regain compliance in connection with its next annual meeting. A Company relying on this provision shall provide notice to Nasdaq immediately upon learning of the event or circumstance that caused the noncompliance.

#### Compensation Committee Charter

Nasdaq proposes to require each Company to certify that it has adopted a formal written compensation committee charter and that the compensation committee will review and reassess the adequacy of the formal written charter on an annual basis.<sup>45</sup> This proposal is similar to Nasdaq's current requirement for Companies to certify as to the adoption of a formal written audit committee charter, except that the proposed requirement for annual review and reassessment of the adequacy of the compensation committee charter is written prospectively, rather than retrospectively.<sup>46</sup> In other words, the proposed compensation committee charter requirement states that the compensation committee will review and reassess the adequacy of the charter on an annual basis, while the current audit committee charter requirement states that the audit committee has reviewed and reassessed the adequacy of the charter on an annual basis.<sup>47</sup>

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<sup>45</sup> Smaller Reporting Companies may adopt either a formal written compensation committee charter or a board resolution that specifies the committee's responsibilities and authority, except Smaller Reporting Companies are not required to specify the specific compensation responsibilities and authority set forth in proposed Nasdaq Listing Rule 5605(d)(3). For further discussion, see the section entitled "Smaller Reporting Companies" below.

<sup>46</sup> See Nasdaq Listing Rule 5605(c)(1).

<sup>47</sup> Nasdaq proposes to make a conforming change to its audit committee charter requirement to clarify that Companies' annual review and reassessment of the audit committee charter should be prospective. This is consistent with Nasdaq's current interpretation of its audit committee charter requirement. By proposing

Nasdaq proposes that the compensation committee charter must specify:

- the scope of the compensation committee's responsibilities, and how it carries out those responsibilities, including structure, processes and membership requirements;
- 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;
- that the chief executive officer of the Company may not be present during voting or deliberations by the compensation committee on his or her compensation; and
- the specific compensation committee responsibilities and authority set forth in proposed Nasdaq Listing Rule 5605(d)(3), which implements the requirements of Section 10C(b)-(e) of the Exchange Act and Rule 10C-1(b)(2), (3) and (4)(i)-(vi) thereunder.

The requirement for the charter to specify the scope of the compensation committee's responsibilities, and how it carries out those responsibilities, including structure, processes and membership requirements, is copied from Nasdaq's similar listing rule relating to audit committee charters.<sup>48</sup>

The requirement for the charter to specify the compensation committee's responsibility for determining, or recommending to the board for determination, the

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this amendment, Nasdaq seeks to minimize differences between the audit committee and compensation committee charter requirements and to eliminate potential questions as to whether Nasdaq intended a discrepancy between these two requirements.

<sup>48</sup> See Nasdaq Listing Rule 5605(c)(1)(A).

compensation of the chief executive officer and all other Executive Officers of the Company, is based upon Nasdaq's current compensation-related listing rules.<sup>49</sup> These listing rules require that the compensation of a Company's chief executive officer and all other Executive Officers must be determined by (i) a compensation committee comprised solely of Independent Directors or (ii) the Independent Directors constituting a majority of the board's Independent Directors in a vote in which only Independent Directors participate. As discussed above, Nasdaq proposes to eliminate the Alternative, and therefore, the compensation of a Company's chief executive officer and all other Executive Officers must be determined, or recommended to the board for determination, by a compensation committee comprised of Independent Directors. Going forward, Nasdaq proposes to implement this requirement by requiring Companies to include it in their formal written compensation committee charters.

The requirement for the charter to specify that the chief executive officer of the Company may not be present during voting or deliberations by the compensation committee on his or her compensation is based upon Nasdaq's current compensation-related listing rules.<sup>50</sup> Going forward, Nasdaq proposes to implement this requirement by requiring Companies to include it in their formal written compensation committee charters.

Finally, the requirement for the charter to specify the specific compensation committee responsibilities and authority set forth in proposed Nasdaq Listing Rule 5605(d)(3) is modeled after Nasdaq's similar listing rule relating to audit committee

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<sup>49</sup> See Nasdaq Listing Rules 5605(d)(1) and (2).

<sup>50</sup> See Nasdaq Listing Rule 5605(d)(1).

charters.<sup>51</sup> Proposed Nasdaq Listing Rule 5605(d)(3) implements the requirements of Section 10C(b)-(e) of the Exchange Act and Rule 10C-1(b)(2), (3) and (4)(i)-(vi) thereunder. Specifically, the proposed listing rule states that a compensation committee must have the specific compensation committee responsibilities and authority necessary to comply with Rule 10C-1(b)(2), (3) and (4)(i)-(vi) 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.<sup>52</sup>

Rule 10C-1 permits Nasdaq to identify other relevant independence factors that a compensation committee must consider when selecting a compensation consultant, legal counsel or other adviser.<sup>53</sup> Nasdaq considered whether to adopt other independence factors, but ultimately concluded that the six independence factors enumerated in Rule

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<sup>51</sup> See Nasdaq Listing Rule 5605(c)(1)(D), which requires that an audit committee charter set forth the specific audit committee responsibilities and authority set forth in Nasdaq Listing Rule 5605(c)(3). Nasdaq Listing Rule 5605(c)(3) states that an audit committee must have the specific responsibilities and authority necessary to comply with Rule 10A-3(b)(2), (3), (4) and (5) under the Exchange Act, with certain exemptions. Rule 10A-3(b)(2), (3), (4) and (5) under the Exchange Act concerns responsibilities relating to: (i) registered public accounting firms; (ii) complaints relating to accounting, internal accounting controls or auditing matters; (iii) authority to engage advisors; and (iv) funding as determined by the audit committee.

<sup>52</sup> The independence factors include: (i) the provision of other services to the issuer by the person that employs the adviser (the “Employer”); (ii) the amount of fees received from the issuer by the Employer, as a percentage of the total revenue of the Employer; (iii) the policies and procedures of the Employer that are designed to prevent conflicts of interest; (iv) any business or personal relationship of the adviser with a member of the compensation committee; (v) any stock of the issuer owned by the adviser; and (vi) any business or personal relationship of the adviser or the Employer with an executive officer of the issuer. See 17 CFR 240.10C-1(b)(4).

<sup>53</sup> Id.

10C-1 will provide compensation committees with a broad and sufficient range of facts and circumstances to consider in making an independence determination. Like the Commission, 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.<sup>54</sup>

### Exemptions

Rule 10C-1 allows the national securities exchanges to exempt from the listing rules adopted pursuant to Rule 10C-1 certain categories of issuers, as the national securities exchange determines is appropriate, taking into consideration, among other relevant factors, the potential impact of the listing rules on smaller reporting issuers.<sup>55</sup> Nasdaq proposes that its existing exemptions from the compensation-related listing rules remain generally unchanged. Nasdaq's current listing rules include exemptions for: asset-backed issuers and other passive issuers,<sup>56</sup> cooperatives,<sup>57</sup> limited partnerships,<sup>58</sup>

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<sup>54</sup> See the Adopting Release, at 38432-3 (stating that “neither the [Dodd-Frank] Act nor [Rule 10C-1] requires a compensation adviser to be independent, only that the compensation committee consider the enumerated independence factors before selecting a compensation adviser. Compensation committees may select any compensation adviser they prefer, including ones that are not independent, after considering the six independence factors outlined in the [Rule 10C-1].”)

<sup>55</sup> See 17 CFR 240.10C-1(b)(5).

<sup>56</sup> See Nasdaq Listing Rule 5615(a)(1). Asset-backed issuers and other passive issuers have traditionally been exempt from Nasdaq's compensation-related listing rules because these issuers do not have a board of directors or persons acting in a similar capacity and their activities are limited to passively owning or holding (as well as administering and distributing amounts in respect of) securities, rights, collateral or other assets on behalf of or for the benefit of the holders of the listed securities. See IM-5615-1.

<sup>57</sup> See Nasdaq Listing Rule 5615(a)(2). Certain member-owned cooperatives that list their preferred stock are required to have their common stock owned by their

management investment companies<sup>59</sup> and Controlled Companies.<sup>60</sup> For the same reasons that these categories of Companies have traditionally been exempt from Nasdaq's compensation-related listing rules, Nasdaq proposes that they continue to be exempt from its revised listing rules relating to compensation committees.

In addition, Nasdaq's current listing rules provide that a Foreign Private Issuer may follow its home country practice in lieu of Nasdaq's compensation-related listing rules if the Foreign Private Issuer discloses in its annual reports filed with the Commission each requirement that it does not follow and describes the home country

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- members. Because of their unique structure and the fact that they do not have a publicly traded class of common stock, these entities have traditionally been exempt from Nasdaq's compensation-related listing rules. See IM-5615-2.
- <sup>58</sup> See Nasdaq Listing Rule 5615(a)(4). Nasdaq's compensation-related listing rules historically have not been applied to limited partnerships because the structure of these entities requires that public investors have limited rights and that the general partners make all significant decisions about the operation of the limited partnership. As such, limited partners do not expect to have a voice in the operations of the partnership. Limited partnerships also are exempt from the independence requirements of Rule 10C-1. See 17 CFR 240.10C-1(b)(1)(iii)(A)(1).
- <sup>59</sup> See Nasdaq Listing Rule 5615(a)(5). Management investment companies registered under the Investment Company Act of 1940 are already subject to a pervasive system of federal regulation in certain areas of corporate governance, and as a result, these entities have traditionally been exempt from Nasdaq's compensation-related listing rules. See IM-5615-4. Open-end management investment companies registered under the Investment Company Act of 1940 also are exempt from the independence requirements of Rule 10C-1. See 17 CFR 240.10C-1(b)(1)(iii)(A)(3).
- <sup>60</sup> See Nasdaq Listing Rule 5615(c). This exemption recognizes that majority Shareholders, including parent companies, have the right to select directors and control certain key decisions, such as executive officer compensation, by virtue of their ownership rights. See IM-5615-5. A Controlled Company is defined as "a Company of which more than 50% of the voting power for the election of directors is held by an individual, a group or another company." Nasdaq Listing Rule 5615(c)(1). Controlled Companies also are exempt from all of the requirements of Rule 10C-1. See 17 CFR 240.10C-1(b)(5)(ii).

practice followed by the Company in lieu of such requirements.<sup>61</sup> Alternatively, a Foreign Private Issuer that is not required to file its annual report with the Commission on Form 20-F may make this disclosure only on its website. Nasdaq proposes that a Foreign Private Issuer continue to be allowed to follow its home country practice in lieu of Nasdaq's revised listing rules relating to compensation committees if the Foreign Private Issuer provides the disclosures described above. Nasdaq also proposes to add an additional disclosure requirement for any Foreign Private Issuer that follows its home country practice in lieu of the requirement to have an independent compensation committee to disclose in its annual reports filed with the Commission the reasons why it does not have such a committee.<sup>62</sup>

#### Phase-In Schedules

Nasdaq proposes that its existing phase-in schedules for the requirements relating to compensation committee composition remain generally unchanged. Nasdaq's current listing rules include phase-in schedules for: Companies listing in connection with an initial public offering,<sup>63</sup> Companies emerging from bankruptcy<sup>64</sup> and Companies ceasing

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<sup>61</sup> See Nasdaq Listing Rule 5615(a)(3). Under Nasdaq's listing rules, Foreign Private Issuer has the same meaning as under Rule 3b-4 under the Exchange Act. See Nasdaq Listing Rule 5005(a)(18). Nasdaq's listing rules have traditionally provided qualified exemptions for foreign private issuers so that such issuers are not required to do any act that is contrary to a law, rule or regulation of any public authority exercising jurisdiction over such issuer or that is contrary to generally accepted business practices in the issuer's country of domicile, except to the extent such exemptions would be contrary to the public securities laws. See Securities Exchange Act Release No. 48745 (November 4, 2003), 68 FR 64154, 64165 (November 12, 2003) (SR-NASD-2002-138).

<sup>62</sup> This proposal adopts the requirements of Rule 10C-1(b)(1)(iii)(A)(4), which provides an exemption from the independence requirements of Rule 10C-1 for a "foreign private issuer that discloses in its annual report the reasons that the foreign private issuer does not have an independent compensation committee."

<sup>63</sup> See Nasdaq Listing Rule 5615(b)(1).

to be Controlled Companies.<sup>65</sup> Since each of these categories of Company did not previously have a compensation committee, each is allowed to phase in compliance with the compensation committee composition requirement as follows: (1) one independent member at the time of listing; (2) a majority of independent members within 90 days of listing; and (3) all independent members within one year of listing. Nasdaq proposes that these phase-in schedules remain unchanged under its revised listing rules, except to clarify that a Company may phase in compliance with the minimum size requirement and the additional eligibility requirements adopted pursuant to Rule 10C-1, as well as the requirement for compensation committee members to be Independent Directors.<sup>66</sup>

In addition, Nasdaq proposes no changes to the phase-in schedule in its current listing rules for Companies transferring from other markets.<sup>67</sup> Companies transferring from other markets with a substantially similar requirement shall be afforded the balance

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<sup>64</sup> See Nasdaq Listing Rule 5615(b)(2).

<sup>65</sup> See Nasdaq Listing Rule 5615(c)(3).

<sup>66</sup> To provide an illustration of how the compensation committee composition requirement will interact with the minimum size requirement, consider a Company that at the time of listing has a compensation committee consisting of two members, both of whom are Independent Directors, but one of whom accepts compensatory fees of \$50,000 annually from the Company pursuant to a consulting agreement. Although only one of these directors is fully eligible to serve on the compensation committee, the committee meets the requirements of Nasdaq's phase-in schedule because it has one fully eligible member at the time of listing. By the 90<sup>th</sup> day from listing, the committee must have a majority of fully eligible members, so the Company could: (i) remove the ineligible member and temporarily have a committee of one fully eligible member; (ii) replace the ineligible member with a fully eligible member so that the committee consists of two members, all of whom are fully eligible; or (iii) add a second fully eligible member so that the committee consists of three members, a majority of whom are fully eligible. By one year from listing, the Company's compensation committee must consist of at least two members, and all members must be fully eligible under Nasdaq's compensation committee composition requirement.

<sup>67</sup> See Nasdaq Listing Rule 5615(b)(3).



of any grace period afforded by the other market. Companies transferring from other listed markets that do not have a substantially similar requirement shall be afforded one year from the date of listing on Nasdaq to comply with the compensation committee composition requirements.

None of the aforementioned phase-in schedules apply to the requirement to adopt a formal written compensation committee charter including the content specified in Nasdaq Listing Rule 5605(d)(1)(A)-(D).<sup>68</sup>

#### Smaller Reporting Companies

While Rule 10C-1 exempts Smaller Reporting Companies from all of its requirements, Nasdaq's current listing rules do not include any such exemptions.<sup>69</sup> Consistent with the exemption in Rule 10C-1, however, Nasdaq proposes not to require Smaller Reporting Companies to adhere to the new requirements relating to compensatory fees and affiliation, which Nasdaq is proposing in response to Rule 10C-1, or to incorporate into their formal written compensation committee charter or board resolution that specifies the committee's responsibilities and authority the language in Rule 10C-1 regarding compensation advisers. This approach will minimize new costs imposed on Smaller Reporting Companies and allow them some flexibility not allowed for larger Companies.

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<sup>68</sup> As discussed below under "Smaller Reporting Companies," Nasdaq is proposing a new phase-in schedule for a Company ceasing to be a Smaller Reporting Company. Nasdaq proposes to allow such a Company 30 days to certify to Nasdaq that it has adopted a formal written compensation committee charter including the content specified in Nasdaq Listing Rule 5605(d)(1)(A)-(D). See footnote 71, infra.

<sup>69</sup> See 17 CFR 240.10C-1(b)(5)(ii).

However, as discussed above, Nasdaq proposes to eliminate the Alternative in its current listing rules that allows compensation decisions to be made by a majority of the Independent Directors rather than by a committee composed entirely of Independent Directors. Nasdaq proposes to eliminate the Alternative for Smaller Reporting Companies, just like all other Nasdaq-listed Companies. As a result, Smaller Reporting Companies would be required to have a compensation committee comprised of at least two Independent Directors as defined under Nasdaq's existing listing rules.

In addition, Nasdaq proposes that Smaller Reporting Companies must adopt a formal written compensation committee charter or board resolution that specifies the committee's responsibilities and authority. Unlike other Companies, Smaller Reporting Companies may include this content in a board resolution, rather than a compensation committee charter, and Smaller Reporting Companies are not required to review and reassess the adequacy of the charter or board resolution on an annual basis. The charter or board resolution must specify the same content as other Companies, except Smaller Reporting Companies are not required to specify the specific compensation responsibilities and authority set forth in proposed Nasdaq Listing Rule 5605(d)(3) 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.<sup>70</sup>

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<sup>70</sup> Nasdaq notes that Smaller Reporting Companies remain subject to the disclosure requirements of Item 407(e)(3)(iv) of Regulation S-K, which were adopted at the same time as Rule 10C-1. See the Adopting Release.

Nasdaq also proposes to apply the same phase-in schedule to a Company ceasing to be a Smaller Reporting Company that applies to a Company listing in conjunction with its initial public offering. Since a Smaller Reporting Company is required to have a compensation committee comprised of at least two Independent Directors, a Company that has ceased to be a Smaller Reporting Company may use the phase-in schedule for the additional eligibility requirements relating to compensatory fees and affiliation, but not for the minimum size requirement or the requirement that the committee consist only of Independent Directors. This phase-in schedule will start to run on the due date of the SEC filing in which the Company is required to report that it is an issuer other than a Smaller Reporting Company.<sup>71</sup> During the phase-in schedule, a Smaller Reporting Company must continue to comply with the requirement to have a compensation committee comprised of at least two Independent Directors as defined under Nasdaq's existing listing rules.

#### Effective Dates/Transition

Nasdaq proposes that Rule 5605(d)(3), relating to compensation committee responsibilities and authority, shall be effective immediately. Specifically, this proposed rule states that a compensation committee must have the specific compensation committee responsibilities and authority necessary to comply with Rule 10C-1(b)(2), (3) and (4)(i)-(vi) under the Act relating to the: (i) authority to retain compensation

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<sup>71</sup> Within 30 days after the start of its phase-in schedule, a Company that has ceased to be a Smaller Reporting Company must certify to Nasdaq that: (i) it has complied with the requirement in Nasdaq Listing Rule 5605(d)(1) to have a compensation committee charter including the content specified in Nasdaq Listing Rule 5605(d)(1)(A)-(D); and (ii) it has, or will within the applicable phase-in schedule, comply with the requirement in Nasdaq Listing Rule 5605(d)(2) regarding compensation committee composition.

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. 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. Companies should consider under state corporate law whether to grant these specific responsibilities and authority through a charter, resolution or other board action; however, Nasdaq proposes to require only that compensation committees immediately have such responsibilities and authority. While Nasdaq proposes that Companies must eventually have a written compensation committee charter that includes, among others, these responsibilities and authority, Companies may implement such a charter on the schedule discussed below.

In order to allow Companies to make necessary adjustments to their boards and committees in the course of their regular annual meeting schedules, Nasdaq proposes that Companies must comply with the remaining provisions of the amended listing rules on compensation committees by the earlier of: (1) their second annual meeting held after the date of approval of Nasdaq's amended listing rules; or (2) December 31, 2014. This transition period is similar to the transition period used when Nasdaq implemented similar requirements for audit committees in 2003.<sup>72</sup>

A Company must certify to Nasdaq, no later than 30 days after the implementation deadline applicable to it, that it has complied with the amended listing

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<sup>72</sup> See Securities Exchange Act Release No. 48745 (November 4, 2003), 68 FR 64154 (November 12, 2003) (SR-NASD-2002-141).

rules on compensation committees. Nasdaq will provide Companies with a form for this certification.

During the transition period, Companies that are not yet required to comply with the amended listing rules on compensation committees must continue to comply with Nasdaq's existing listing rules, which have been redesignated as Listing Rule 5605A(d) and IM-5605A-6 in Nasdaq's proposal.

#### Conforming Changes and Correction of Typographical Errors

Finally, Nasdaq proposes to make minor conforming changes to its requirements relating to audit and nominations committees. Nasdaq also proposes to correct certain typographical errors in its corporate governance requirements as set forth in Exhibit 5.

### 2. Statutory Basis

Nasdaq believes that the proposed rule change is consistent with the provisions of Section 6 of the Exchange Act,<sup>73</sup> in general, and with Section 6(b)(5) of the Exchange Act,<sup>74</sup> in particular. Section 6(b)(5) requires, among other things, that a national securities exchange's rules must be designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, to remove impediments to and perfect the mechanism of a free and open market and a national market system and, in general, to protect investors and the public interest. Section 6(b)(5) also requires that a national securities exchange's rules not be designed to permit unfair discrimination between customers, issuers, brokers or dealers.

As required by the Dodd-Frank Act and Rule 10C-1, Nasdaq is proposing amendments to its listing rules relating to the independence of compensation committees

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<sup>73</sup> 15 U.S.C. 78f.

<sup>74</sup> 15 U.S.C. 78f(b)(5).

and their advisers. Nasdaq reviewed its existing compensation-relating listing rules, in combination with the requirements of Rule 10C-1, to develop a set of proposed compensation-related listing rules. These proposals generally fall into three categories: proposed rule amendments to comply with Rule 10C-1; proposals to continue certain rules relatively unchanged; and proposed rule amendments not required by Rule 10C-1. Nasdaq believes that collectively, these proposals protect investors and the public interest by requiring Companies, with certain exemptions, to have a compensation committee meeting certain requirements relating to composition, responsibilities and authority.

More specifically, Nasdaq's proposed amendments to its listing rules in order to comply with Rule 10C-1 set forth: additional eligibility requirements for compensation committee members relating to compensatory fees and affiliation; an opportunity to cure defects in compensation committee composition; a requirement that compensation committees have the specific responsibilities and authority necessary to comply with Rule 10C-1(b)(2), (3) and (4)(i)-(vi) under the Exchange Act; and exemptions for limited partnerships, management investment companies, Controlled Companies, foreign private issuers that provide certain required disclosures, and Smaller Reporting Companies. Nasdaq believes that its proposals fairly balance the goal of protecting the investing public by ensuring effective deliberation over executive compensation with the goal of avoiding the imposition of undue costs on Companies.

Nasdaq's proposals to continue relatively unchanged some of its existing exemptions to the compensation-related listing rules for certain categories of Companies takes into account the unique characteristics of these Companies.<sup>75</sup> As a result, Nasdaq

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<sup>75</sup> See footnotes 56-61, supra.

does not believe that continuing these exemptions will discriminate unfairly among issuers, consistent with Section 6(b)(5) of the Exchange Act.<sup>76</sup>

The proposed rule amendments not required by Rule 10C-1 require that: Companies must have a standing compensation committee; the committee must consist of a minimum of two members; the committee must have a formal written charter (or board resolution, in the case of Smaller Reporting Companies) that specifies the committee's responsibilities and authority; and Smaller Reporting Companies must continue to comply with certain of Nasdaq's compensation-related listing rules. As discussed in the "Purpose" section, Nasdaq believes that these new requirements will facilitate effective oversight of executive compensation and promote accountability to investors for executive compensation decisions. With regard to Smaller Reporting Companies, Nasdaq notes that these Companies continue to be subject to the same requirements as all other Companies, except the new requirements that Nasdaq is proposing under Rule 10C-1 relating to compensatory fees, affiliation and the specific compensation committee responsibilities and authority set forth in proposed Nasdaq Listing Rule 5605(d)(3). Nasdaq believes that this hybrid approach does not discriminate unfairly between issuers because it recognizes the fact that the "executive compensation arrangements of [Smaller Reporting Companies] generally are so much less complex than those of other public companies that they do not warrant the more extensive disclosure requirements imposed on companies that are not [Smaller Reporting Companies] and related regulatory burdens that could be disproportionate for [Smaller Reporting Companies]."<sup>77</sup> In

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<sup>76</sup> 15 U.S.C. 78f(b)(5).

<sup>77</sup> See the Adopting Release, at 38438 (quoting Securities Exchange Act Release No. 54302A (August 29, 2006), 71 FR 53158, 53192 (September 8, 2006)).

addition, Nasdaq notes that the Commission exempted Smaller Reporting Companies from Rule 10C-1.<sup>78</sup> As a result, this distinction does not discriminate unfairly among issuers.

B. Self-Regulatory Organization's Statement on Burden on Competition

Nasdaq does not believe that the proposed rule change will result in any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Exchange Act, as amended.

C. Self-Regulatory Organization's Statement on Comments on the Proposed Rule Change Received from Members, Participants, or Others

Nasdaq did not solicit comments on the proposed rule change. Nasdaq received two written comments, which are attached as Exhibit 2.

The first commenter recommended that Nasdaq should require Companies to disclose: (i) how they are complying with the requirement to consider the independence factors enumerated in Rule 10C-1; and (ii) the nature of any conflict of interest arising from the engagement of legal counsel by a compensation committee. Nasdaq considered these recommendations, but it preferred to defer to the judgment of the Commission with respect to the appropriate disclosure framework under Rule 10C-1. Nasdaq therefore decided not to propose any new disclosure requirements for Companies, other than those that are required by Rule 10C-1.<sup>79</sup>

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<sup>78</sup> See 17 CFR 240.10C-1(b)(5)(ii).

<sup>79</sup> Specifically, as required by Rule 10C-1(b)(1)(iii)(A)(4), Nasdaq proposes to require a Foreign Private Issuer that follows a home country practice in lieu of the requirement to have an independent compensation committee to disclose the reasons why it does not have such a committee.



The second commenter proffered four recommendations. First, this commenter recommended that Nasdaq include director fees within the list of relevant factors that must be considered when assessing the independence of compensation committee members. Nasdaq does not believe that the intent of the Dodd-Frank Act or Rule 10C-1 was to limit independence based on director compensation, and therefore, Nasdaq proposes to continue to exempt board fees from its prohibition on payment of compensatory fees to a compensation committee member. Second, this commenter recommended that Nasdaq include in the requirements for compensation committee independence a factor relating to business or personal relationships between directors and officers. As discussed in the “Purpose” section above, Nasdaq reviewed its current and proposed listing rules and concluded that these rules are sufficient to ensure the independence of compensation committee members. Therefore, Nasdaq determined not to propose further independence requirements, other than those discussed above. Third, this commenter recommended that Nasdaq expand the additional factors for compensation committee eligibility to cover all independent directors, not just those serving on the compensation committee. While Nasdaq heavily weighed the commenter’s concern that multiple definitions of independence add to the complexity of board membership, Nasdaq believed that the intent of the Dodd-Frank Act and Rule 10C-1 was to address the independence of compensation committee members, as well as their advisers, specifically. Nasdaq concluded therefore that it is inappropriate to expand the additional requirements proposed herein to cover all independent directors. Finally, this commenter recommended that Nasdaq clarify that, while the factors must be considered in their totality, a single factor can result in a loss of director independence.

Nasdaq confirms that a director cannot be deemed independent if he or she fails any one of the bright-line prohibitions in Nasdaq Listing Rule 5605(a)(2).

III. Date of Effectiveness of the Proposed Rule Change and Timing for Commission Action

Within 45 days of the date of publication of this notice in the Federal Register or within such longer period (i) as the Commission may designate up to 90 days of such date if it finds such longer period to be appropriate and publishes its reasons for so finding or (ii) as to which the Exchange consents, the Commission will: (a) by order approve such proposed rule change, or (b) institute proceedings to determine whether the proposed rule change should be disapproved.

IV. Solicitation of Comments

Interested persons are invited to submit written data, views, and arguments concerning the foregoing, including whether the proposed rule change, as amended, is consistent with the Exchange Act. Comments may be submitted by any of the following methods:

Electronic comments:

- Use the Commission's Internet comment form (<http://www.sec.gov/rules/sro.shtml>); or
- Send an e-mail to [rule-comments@sec.gov](mailto:rule-comments@sec.gov). Please include File Number SR-NASDAQ-2012-109 on the subject line.

Paper comments:

- Send paper comments in triplicate to Elizabeth M. Murphy, Secretary, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-1090.

All submissions should refer to File Number SR-NASDAQ-2012-109. This file number should be included on the subject line if e-mail is used.

To help the Commission process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet Web site (<http://www.sec.gov/rules/sro.shtml>). Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for website viewing and printing in the Commission's Public Reference Room on official business days between the hours of 10:00 a.m. and 3:00 p.m. Copies of such filing also will be available for inspection and copying at the principal offices of Nasdaq. All comments received will be posted without change; the Commission does not edit personal identifying information from submissions. You should submit only information that you wish to make available publicly.

All submissions should refer to File Number SR-NASDAQ-2012-109, and should be submitted on or before [insert date 21 days from publication in the Federal Register].

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.<sup>80</sup>

Kevin M. O'Neill  
Deputy Secretary

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<sup>80</sup> 17 CFR 200.30-3(a)(12).

**EXHIBIT 2**

**From:** Robert M. Fields [<mailto:rmfields@rmfieldslaw.com>]  
**Sent:** Monday, June 25, 2012 08:13 PM  
**To:** Michael Emen  
**Subject:** Listing Standards Mandated Under Section 952 of Dodd-Frank

Mr. Emen: As we briefly discussed last week, on June 20th of this year, the United States Securities and Exchange Commission (the “SEC”) published Final Rules under Section 952 of Dodd-Frank dealing with the independence of members of compensation committees of listed issuers and with the independence of compensation consultants and legal counsel providing services to such compensation committees. Contained in the Final Rules is a requirement that the national securities exchanges promulgate listing standards enforcing certain provisions of Section 952.

Section 10C(b) of the Securities Exchange Act of 1934, as amended (the “Exchange Act”), enacted into law under Section 952 of Dodd-Frank, provides that compensation committees of listed issuers may select compensation consultants, legal counsel and other compensation advisors only after taking into account certain independence factors identified by the SEC. New SEC Regulation Section 240.10C-1 provides that the national securities exchanges must adopt listing standards requiring the listed issuers to consider such independence factors. I believe that the listing standards to be issued by NASDAQ, as well as by the other stock exchanges, should require the listed issuers to publicly disclose in their annual certification, a press release or other public statements how they are complying with the requirement to consider these independence factors.

From the prosaic requirement that automobile owners must show proof that they have obtained liability insurance before they can register their cars, to the more germane rule providing that that listed issuers must disclose the opinions of their independent auditors (in order to publicly establish that such audits actually took place), a common theme has evolved: In virtually all situations where a statute, regulation or other rule requires a person to engage in an action or activity, establishment of proof of the accomplishment of such action or activity is required. Accordingly, some mechanism should be established by the national securities exchanges to assure the SEC, NASDAQ and investors that the requirements of Section 10C(b) of the Exchange Act have been carried out.

New SEC Regulation Section 229.407(e)(3)(iv) provides that certain publicly traded corporations must disclose in their annual proxy statements the nature of any conflict that arises from the engagement of a compensation consultant identified in the proxy statement. I believe that there is no rational reason why the same standard should not apply to legal counsel engaged by compensation committees. Thus, I encourage NASDAQ to require, in its listing standards, that such additional disclosure must be made, either in a publicly-disclosed annual certification, press release or another publicly-issued statement.

Adequate disclosure would provide transparency to the compensation consultant and legal counsel selection process and would also provide useful information to investors (which, in the grand scheme of things, is what Congress is encouraging under Dodd-Frank). Nevertheless,

the required disclosure need not be extensive or overly burdensome on the listed issuers. A paragraph generally describing how the listed issuers' compensation committees addressed the requirements of Section 10C(b) of the Exchange Act, and whether or not they elected to utilize the services of independent consultants, legal counsel or other compensation advisors (and why they did or did not make such an election), should be sufficient. Furthermore, this disclosure need not be made on an annual basis. Once every five years (or more frequently in the event (i) the listed issuers engage one or more new consultants, legal counsel or other compensation advisors or (ii) relevant facts change) should suffice.

Thank you for your time and consideration of this matter. Please do not hesitate to contact me at your convenience if you have any questions or comments. If you would, kindly confirm your receipt of this message.

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August 2, 2012

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Re: Rule 10C-1

Ladies & Gentlemen:

As you know, the Securities and Exchange Commission ("SEC") recently promulgated Rule 10C-1. 17 CFR 240.10C-1.<sup>1</sup> Mandated by Section 952 of Dodd-Frank,<sup>2</sup> the Rule requires national securities exchanges to adopt listing standards that govern compensation committees. Among other things, the exchanges are obligated to propose standards that discuss the "factors relevant to compensation committee independence" and that include "the definition of independence applicable to compensation committee members". Rule 10C-1(a)(4), 17 CFR 240.10C-1(a)(4). The proposal must be promulgated within 90 days.

In defining relevant factors, the exchanges will need to take into account a number of matters. First, as Dodd-Frank requires, the exchanges should specify that the relevant factors include the fees paid by directors in return for service on the board. Second, the relevant factors should explicitly include consideration of the personal and business relationships between directors and officers. Third, the exchanges should clarify that the relevant factors apply to the consideration of independence for all directors, not just those serving on the compensation

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<sup>1</sup> I was recently appointed to, and elected Secretary of, the Investor Advisory Committee created by the Securities and Exchange Commission. See <http://www.sec.gov/news/press/2012/2012-58.htm>. Please note that the opinions expressed in this letter are my own and do not reflect the views of the Commission or the Investor Advisory Committee.

<sup>2</sup> See Section 952, Pub. L. No. 111-203, 124 Stat. 1900 (2010). A copy of the final legislation is here: <http://www.gpo.gov/fdsys/pkg/PLAW-111publ203/pdf/PLAW-111publ203.pdf>

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committee. Finally, the listing standards should specify that, while the factors must be considered in their totality, a single factor can result in the loss of director independence.

## I. Existing Factors

In mandating the development of “relevant factors,” Congress in Section 10C specified two of them. These included: (A) The source of compensation of a member of the board of directors of an issuer, including any consulting, advisory or other compensatory fee paid by the issuer to such member of the board of directors; and (B) Whether a member of the board of directors of an issuer is affiliated with the issuer, a subsidiary of the issuer, or an affiliate of a subsidiary of the issuer.<sup>3</sup>

This is not the first time that Congress has expressed concern over the compensation received by directors or their affiliations. Section 10A of the Exchange Act, a provision adopted in Sarbanes Oxley, prohibited directors who had certain affiliations or who received certain types of compensation from serving on the audit committee.<sup>4</sup> These mandates were implemented in Rule 10A-3. 17 CFR § 240.10A-3.

Dodd-Frank, however, took a different approach. Congress did not impose substantive standards for membership on the compensation committee. Instead, Congress merely required consideration of “relevant factors.” The approach allowed Congress to take a broader view toward the matters that must be considered in determining director independence.

This shift in approach can be seen by comparing the language in Section 10A and Section 10C. Section 10A prohibits a director from serving on the audit committee if he or she accepts “any consulting, advisory, or other compensatory fee from the issuer . . .”<sup>5</sup> Under the express language, the disqualifying payment must come from the issuer and must resemble consulting or advisory fees. It does not include fees paid to directors for their service on the board.

Section 10C, in contrast, contains much broader language. The provision requires consideration of the “source of compensation of a member of the board of directors of an issuer . . .”<sup>6</sup> The provision is not limited to compensation paid by the issuer. Nor is it restricted to payments that resemble consulting or advisory fees.<sup>7</sup> Instead it applies to *all* compensation paid to a director.

Fees paid for service on the board are a form of compensation. *See* Item 402 of Regulation S-K, 17 CFR § 229.402 (providing for disclosure of fees in a table labeled “director compensation”). As a result, the broad language of Section 10C requires that these fees be included within the list of relevant factors. Even without the language in Section 10C, directors’

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<sup>3</sup> 15 U.S.C. § 78j-3.

<sup>4</sup> 15 U.S.C. § 78j-1.

<sup>5</sup> 15 U.S.C. § 78j-1.

<sup>6</sup> 15 U.S.C. § 78j-3(a)(3)(A)

<sup>7</sup> While the language of Section 10C does refer to any “consulting, advisory, or other compensatory fee paid by the issuer,” they do not purport to be a definitive list of applicable payments.



fees would need to be included. Fees can amount to a material payment from the issuer,<sup>8</sup> something the exchanges have recognized.<sup>9</sup>

The exchanges should, therefore, explicitly acknowledge that director compensation under Section 10C includes fees for service on the board and must be considered as a relevant factor. In addition, the listing standard should make clear that director fees must not be considered in isolation but in conjunction with other compensation paid by the issuer.<sup>10</sup>

## II. Additional Factors

The factors listed in Section 10C are not exclusive. The exchanges may identify other “relevant factors” that must be considered in determining director independence.<sup>11</sup> In promulgating Rule 10C-1, the Commission set out a number of other factors that the exchanges should include in the relevant listing standard.

The Commission emphasized “that it is important for exchanges to consider other ties between a listed issuer and a director, in addition to share ownership, that might impair the director’s judgment as a member of the compensation committee.” Specifically, the Commission noted that the exchanges “might conclude that personal or business relationships between members of the compensation committee and the listed issuer’s executive officers should be addressed in the definition of independence.”<sup>12</sup>

It is particularly important that, in identifying the “relevant factors,” the exchanges make clear that they include any personal or business relationships between directors and executive officers. These types of relationships can impair independence,<sup>13</sup> something at least one exchange has noted.<sup>14</sup>

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<sup>8</sup> Total compensation for directors can exceed \$1 million for service on the board. See Apple Proxy Statement (filed in 2011) (total compensation of two directors exceeded \$1 million), *available at* <http://sec.gov/Archives/edgar/data/320193/000119312511003231/ddef14a.htm>

<sup>9</sup> See 303A.09 Corporate Governance Guidelines (“The board should be aware that questions as to directors’ independence may be raised when directors’ fees and emoluments exceed what is customary.”).

<sup>10</sup> The rules of the exchanges permit the payment to independent directors of some non-fee compensation. See 303A.02 Independence Tests (“The director has received, or has an immediate family member who has received, during any twelve-month period within the last three years, more than \$120,000 in direct compensation from the listed company, other than director and committee fees and pension or other forms of deferred compensation for prior service (provided such compensation is not contingent in any way on continued service).”); *see also* Nasdaq Rule 5605(a)(2)(B).

<sup>11</sup> See Exchange Act Release No. 67220 (June 20, 2012) (“Section 10C gives the exchanges the flexibility to establish their own minimum independence criteria for compensation committee members after considering relevant factors, including the two enumerated in Section 10C(a)(3).”).

<sup>12</sup> Exchange Act Release No. 67220 (June 20, 2012).

<sup>13</sup> See generally J. Robert Brown, Jr., *Disloyalty Without Limits: 'Independent' Directors and the Elimination of the Duty of Loyalty*, 95 KY L. Rev. 53 (2006-2007), *available at* [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=959434](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=959434)

<sup>14</sup> See <http://www.theracetothetbottom.org/independent-directors/the-nyse-and-the-problems-of-director-independence-the-non-t.html> (NYSE official said to have advised “that, in interpreting its rules, the NYSE believes relationships between a director and a member of senior management that are material to either party should be



At the same time, making the factor explicit will clarify an ambiguity in the rules of the exchanges. The NYSE only requires that boards, in determining director independence, consider whether the director has a material relationship “with the listed company . . . ”<sup>15</sup> The Nasdaq uses similar language.<sup>16</sup>

Some companies have apparently interpreted the language to suggest that independence does not require consideration of the business and personal relationships between directors and officers.<sup>17</sup> Representatives of the NYSE have disagreed with this interpretation.<sup>18</sup> Nonetheless, by making these factors explicit, the exchanges will avoid any erroneous interpretations of their existing listing standards.

### III. Simplification

Currently the exchanges provide two different standards for director independence. Each of the exchanges has a definition applicable to all directors. With respect to directors who serve on the audit committee, however, there is a separate definition. *See* Rule 10A-3, 17 CFR 240.10A-3. To the extent that the exchanges limit the factors required by Section 10C to compensation committees, it will effectively be putting in place a third set of criteria for director independence.

The presence of three standards adds to the complexity of board membership. Moreover, it limits the ability of independent directors to sit on the various committees. Particularly when vacancies occur, boards may find themselves with an inadequate supply of directors who meet the standards for each respective committee.

The exchanges should, therefore, specify that the “relevant factors” must be considered when determining the independence of all directors on the board, not just those assigned to the compensation committee. Doing so will simplify the board structure and allow all independent directors to be eligible to sit on the compensation committee.

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considered by a board of directors in its evaluation of a director’s independence.”). *See also* Commentary to NYSE Rule 303A.02(a) (with respect to director independence, “the concern is independence from management”).

<sup>15</sup> *See* NYSE Manual 303A.02(a).

<sup>16</sup> Nasdaq provides that independence can be lost by “having a relationship, which, in the opinion of the Company’s board of directors, would interfere with the exercise of independent judgment”. Nasdaq Rule 5605(a)(2), available at

[http://nasdaq.cchwallstreet.com/NASDAQTools/PlatformViewer.asp?selectednode=chp\\_1\\_1\\_4\\_2&manual=%2Fnasdaq%2Fmain%2Fnasdaq-equityrules%2F](http://nasdaq.cchwallstreet.com/NASDAQTools/PlatformViewer.asp?selectednode=chp_1_1_4_2&manual=%2Fnasdaq%2Fmain%2Fnasdaq-equityrules%2F). Although not limited to relationships with the issuer, the accompanying interpretation of the standard provides that investors must have confidence that “individuals serving as Independent Directors do not have a relationship with the listed Company that would impair their independence.” IM-5605. Definition of Independence — Rule 5605(a)(2).

<sup>17</sup> At least one NYSE traded company interpreted this language to mean that personal business relationships between directors and officers “generally are not relevant to the independence tests under the New York Stock Exchange rules because they do not create a material relationship between a director and the company.” *See* <http://www.theracetothetbottom.org/independent-directors/2010/6/1/the-nyse-and-the-problems-of-director-independence-the-plain.html>

<sup>18</sup> *See supra* note 14.

The approach will also avoid an unnecessary negative implication. By limiting the relevant factors to directors serving on the compensation committee, the exchanges arguably create an implication that these factors need not be considered when determining director independence in other circumstances. This is inconsistent with existing interpretation and, as a result, may lead to boards mistakenly characterizing directors as independent.<sup>19</sup>

#### IV. Clarifications

In adopting Rule 10C-1, the SEC suggested in the adopting release that no single factor would determine director independence. *See* Exchange Act Release No. 67220 (June 20, 2012) (noting that the factors contained in Rule 10C-1 "should be considered in their totality and that no one factor should be viewed as a determinative factor of independence.").

The statement correctly notes that the factors should be examined in their totality. The exchanges should, however, clarify that a single factor can still result in the loss of independence. Thus, for example, a director might lose his or her independence based upon a material personal or business relationship with other directors or executive officers, irrespective of the application of the other factors. This clarifying interpretation will help boards avoid making erroneous determinations with respect to director independence.

#### V. Conclusion

Director independence is a critical component of the existing system of corporate governance. By defining a rigorous and comprehensive set of "relevant factors" that must be considered by the board in determining director independence, the exchanges will fulfill the mandates of Dodd-Frank and better ensure investor confidence in the securities markets.

If you would like to discuss this matter further, please do not hesitate to contact me.

With best regards,

Yours truly,



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<sup>19</sup> *See supra* notes 9 & 14.



**EXHIBIT 5**Text of the Proposed Rule Change<sup>1</sup>

New language is underlined; deletions are in [brackets].

**5605. Board of Directors and Committees****(a) Definitions****(1) No change.**

**(2)** “Independent Director” means a person other than an Executive Officer or employee of the Company or any other individual having a relationship which, in the opinion of the Company’s board of directors, would interfere with the exercise of independent judgment in carrying out the responsibilities of a director. For purposes of this rule, “Family Member” means a person’s spouse, parents, children and siblings, whether by blood, marriage or adoption, or anyone residing in such person’s home. The following persons shall not be considered independent:

**(A) – (B) No change.**

**(C)** a director who is a Family Member of an individual who is, or at any time during the past three years was, employed by the [c]Company as an Executive Officer;

**(D) – (G) No change.*****IM-5605. Definition of Independence — Rule 5605(a)(2)***

\* \* \* \* \*

*Paragraph (G) of the Rule provides a different measurement for independence for investment companies in order to harmonize with the Investment Company Act of 1940. In particular, in lieu of paragraphs (A)-(F), a director who is an “interested person” of the [c]Company as defined in Section 2(a)(19) of the Investment Company Act of 1940, other than in his or her capacity as a member of the board of directors or any board committee, shall not be considered independent.*

**(b) No change.****(c) Audit Committee Requirements**

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<sup>1</sup> Changes are marked to the rule text that appears in the electronic Nasdaq Manual found at <http://nasdaq.cchwallstreet.com>.

**(1) Audit Committee Charter**

Each Company must certify that it has adopted a formal written audit committee charter and that the audit committee [has reviewed and reassessed]will review and reassess the adequacy of the formal written charter on an annual basis. The charter must specify:

(A) the scope of the audit committee's responsibilities, and how it carries out those responsibilities, including structure, processes[,]  
and membership requirements;

(B) the audit committee's responsibility for ensuring its receipt from the outside auditors of a formal written statement delineating all relationships between the auditor and the Company, actively engaging in a dialogue with the auditor with respect to any disclosed relationships or services that may impact the objectivity and independence of the auditor and for taking, or recommending that the full board take, appropriate action to oversee the independence of the outside auditor; [and]

(C) the committee's purpose of overseeing the accounting and financial reporting processes of the Company and the audits of the financial statements of the Company; and

(D) the specific audit committee responsibilities and authority set forth in Rule 5605(c)(3).

**IM-5605-3. No change.**

**(2) Audit Committee Composition**

(A) Each Company must have, and certify that it has and will continue to have, an audit committee of at least three members, each of whom must: (i) be [independent]an Independent Director as defined under Rule 5605(a)(2); (ii) meet the criteria for independence set forth in Rule 10A-3(b)(1) under the Act (subject to the exemptions provided in Rule 10A-3(c) under the Act); (iii) not have participated in the preparation of the financial statements of the Company or any current subsidiary of the Company at any time during the past three years; and (iv) be able to read and understand fundamental financial statements, including a Company's balance sheet, income statement, and cash flow statement. Additionally, each Company must certify that it has, and will continue to have, at least one member of the audit committee who has past employment experience in finance or accounting,

requisite professional certification in accounting, or any other comparable experience or background which results in the individual's financial sophistication, including being or having been a chief executive officer, chief financial officer or other senior officer with financial oversight responsibilities.

**(B) Non-Independent Director for Exceptional and Limited Circumstances**

Notwithstanding paragraph (2)(A)(i), one director who: (i) is not ~~[independent]~~an Independent Director as defined in Rule 5605(a)(2); (ii) meets the criteria set forth in Section 10A(m)(3) under the Act and the rules thereunder; and (iii) is not currently an Executive Officer or employee or a Family Member of an Executive Officer, may be appointed to the audit committee, if the board, under exceptional and limited circumstances, determines that membership on the committee by the individual is required by the best interests of the Company and its Shareholders. A Company, other than a Foreign Private Issuer, that relies on this exception must comply with the disclosure requirements set forth in Item 407(d)(2) of Regulation S-K. A Foreign Private Issuer that relies on this exception must disclose in its next annual report (e.g., Form 20-F or 40-F) the nature of the relationship that makes the individual not independent and the reasons for the board's determination. A member appointed under this exception may not serve longer than two years and may not chair the audit committee.

***IM-5605-4. Audit Committee Composition***

*Audit committees are required to have a minimum of three members and be comprised only of Independent Directors. In addition to satisfying the Independent Director requirements under Rule 5605(a)(2), audit committee members must meet the criteria for independence set forth in Rule 10A-3(b)(1) under the Act (subject to the exemptions provided in Rule 10A-3(c) under the Act): they must not accept any consulting, advisory, or other compensatory fee from the Company other than for board service, and they must not be an affiliated person of the Company. As described in Rule 10A-3(d)(1) and (2), a Company must disclose reliance on certain exceptions from Rule 10A-3 and disclose an assessment of whether, and if so, how, such reliance would materially adversely affect the ability of the audit committee to act independently and to satisfy the other requirements of Rule 10A-3. It is recommended also that a Company disclose in its annual proxy (or, if the Company does not file a proxy, in its Form 10-K or 20-F) if any director is deemed ~~[independent]~~eligible to serve on the audit committee but falls outside the safe harbor provisions of Rule 10A-3(e)(1)(ii) under the Act. A director who qualifies as an audit committee financial expert under Item 407(d)(5)(ii) and (iii) of Regulation S-K is presumed to qualify as a financially sophisticated audit committee member under Rule 5605(c)(2)(A).*

**(3) Audit Committee Responsibilities and Authority**

The audit committee must have the specific audit committee responsibilities and authority necessary to comply with Rule 10A-3(b)(2), (3), (4) and (5) under the Act (subject to the exemptions provided in Rule 10A-3(c) under the Act), concerning responsibilities relating to: (i) registered public accounting firms, (ii) complaints relating to accounting, internal accounting controls or auditing matters, (iii) authority to engage [advisors]advisers, and (iv) funding as determined by the audit committee. Audit committees for investment companies must also establish procedures for the confidential, anonymous submission of concerns regarding questionable accounting or auditing matters by employees of the investment adviser, administrator, principal underwriter, or any other provider of accounting related services for the investment company, as well as employees of the investment company.

***IM-5605-5. The Audit Committee Responsibilities and Authority***

*Audit committees must have the specific audit committee responsibilities and authority necessary to comply with Rule 10A-3(b)(2), (3), (4) and (5) under the Act (subject to the exemptions provided in Rule 10A-3(c) under the Act), concerning responsibilities relating to registered public accounting firms; complaints relating to accounting; internal accounting controls or auditing matters; authority to engage [advisors]advisers; and funding. Audit committees for investment companies must also establish procedures for the confidential, anonymous submission of concerns regarding questionable accounting or auditing matters by employees of the investment adviser, administrator, principal underwriter, or any other provider of accounting related services for the investment company, as well as employees of the investment company.*

**(4) – (5) No change.****[(d) Independent Director Oversight of Executive Officer Compensation**

**(1)** Compensation of the chief executive officer of the Company must be determined, or recommended to the Board for determination, either by:

**(A)** Independent Directors constituting a majority of the Board's Independent Directors in a vote in which only Independent Directors participate; or

**(B)** a compensation committee comprised solely of Independent Directors.

The chief executive officer may not be present during voting or deliberations.

(2) Compensation of all other Executive Officers must be determined, or recommended to the Board for determination, either by:

(A) Independent Directors constituting a majority of the Board's Independent Directors in a vote in which only Independent Directors participate; or

(B) a compensation committee comprised solely of Independent Directors.

**(3) Non-Independent Committee Member under Exceptional and Limited Circumstances**

Notwithstanding paragraphs 5605(d)(1)(B) and 5605(d)(2)(B) above, if the compensation committee is comprised of at least three members, one director who is not independent as defined in Rule 5605(a)(2) and is not currently an Executive Officer or employee or a Family Member of an Executive Officer, may be appointed to the compensation committee if the board, under exceptional and limited circumstances, determines that such individual's membership on the committee is required by the best interests of the Company and its Shareholders. A Company that relies on this exception must disclose either on or through the Company's website or in the proxy statement for the next annual meeting subsequent to such determination (or, if the Company does not file a proxy, in its Form 10-K or 20-F), the nature of the relationship and the reasons for the determination. In addition, the Company must provide any disclosure required by Instruction 1 to Item 407(a) of Regulation S-K regarding its reliance on this exception. A member appointed under this exception may not serve longer than two years.

***IM-5605-6. Independent Director Oversight of Executive Compensation***

*Independent director oversight of executive officer compensation helps assure that appropriate incentives are in place, consistent with the board's responsibility to maximize shareholder value. The rule is intended to provide flexibility for a Company to choose an appropriate board structure and to reduce resource burdens, while ensuring Independent Director control of compensation decisions.]*

**(d) Compensation Committee Requirements**

**(1) Compensation Committee Charter**

Each Company must certify that it has adopted a formal written compensation committee charter and that the compensation committee

will review and reassess the adequacy of the formal written charter on an annual basis. The charter must specify:

(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;

(C) that the chief executive officer may not be present during voting or deliberations on his or her compensation; and

(D) the specific compensation committee responsibilities and authority set forth in Rule 5605(d)(3).

## **(2) Compensation Committee Composition**

(A) Each Company must have, and certify that it has and will continue to have, a compensation committee of at least two members, each of whom must: (i) be an Independent Director as defined under Rule 5605(a)(2); and (ii) not accept directly or indirectly any consulting, advisory or other compensatory fee from the Company or any subsidiary thereof. Compensatory fees shall not include: (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). 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.

### **(B) Non-Independent Committee Member under Exceptional and Limited Circumstances**

Notwithstanding paragraph 5605(d)(2)(A) above, if the compensation committee is comprised of at least three members, one director who does not meet the requirements of paragraph 5605(d)(2)(A) and is not currently an Executive Officer or



employee or a Family Member of an Executive Officer, may be appointed to the compensation committee if the board, under exceptional and limited circumstances, determines that such individual's membership on the committee is required by the best interests of the Company and its Shareholders. A Company that relies on this exception must disclose either on or through the Company's website or in the proxy statement for the next annual meeting subsequent to such determination (or, if the Company does not file a proxy, in its Form 10-K or 20-F), the nature of the relationship and the reasons for the determination. In addition, the Company must provide any disclosure required by Instruction 1 to Item 407(a) of Regulation S-K regarding its reliance on this exception. A member appointed under this exception may not serve longer than two years.

### **(3) Compensation Committee Responsibilities and Authority**

The compensation committee must have the specific compensation committee responsibilities and authority necessary to comply with Rule 10C-1(b)(2), (3) and (4)(i)-(vi) under the Act 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.

### **(4) Cure Period for Compensation Committee**

If a Company fails to comply with the compensation committee composition requirement under Rule 5605(d)(2)(A) due to one vacancy, or one compensation committee member ceases to be independent due to circumstances beyond the member's reasonable control, the Company shall regain compliance with the requirement by the earlier of its next annual shareholders meeting or one year from the occurrence of the event that caused the failure to comply with this requirement; provided, however, that if the annual shareholders meeting occurs no later than 180 days following the event that caused the failure to comply with this requirement, the Company shall instead have 180 days from such event to regain compliance. A Company relying on this provision shall provide notice to Nasdaq immediately upon learning of the event or circumstance that caused the noncompliance.

### **(5) Smaller Reporting Companies**

A Smaller Reporting Company, as defined in Rule 12b-2 under the Act, is not subject to the requirements of Rule 5605(d), except that a Smaller Reporting Company must have, and certify that it has and will continue to

have, a compensation committee of at least two members, each of whom must be an Independent Director as defined under Rule 5605(a)(2). A Smaller Reporting Company may rely on the exception in Rule 5605(d)(2)(B) and the cure period in Rule 5605(d)(4). In addition, a Smaller Reporting Company must certify that it has adopted a formal written compensation committee charter or board resolution that specifies the content set forth in Rule 5605(d)(1)(A)-(C). A Smaller Reporting Company does not need to include in its formal written compensation committee charter or board resolution the specific compensation committee responsibilities and authority set forth in Rule 5605(d)(3).

#### **(6) Effective Dates/Transition**

The provisions of Rule 5605(d)(3) shall be effective immediately; 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. Companies should consider under state corporate law whether to grant the specific responsibilities and authority referenced in Rule 5605(d)(3) through a charter, resolution or other board action; however, Nasdaq requires only that compensation committees immediately have such responsibilities and authority. While Companies must eventually have a written compensation committee charter that includes, among others, these responsibilities and authority, Companies may implement such a charter on the schedule discussed below.

In order to allow Companies to make necessary adjustments in the course of their regular annual meeting schedule, the remaining provisions of Rule 5605(d) and IM-5605-6 shall be implemented by the Company's second annual meeting held after the date of approval of Nasdaq's rule proposal contained in SR-NASDAQ-2012-109, but no later than December 31, 2014. A Company must certify to Nasdaq, no later than 30 days after the implementation deadline applicable to it, that it has complied with the amended listing rules on compensation committees. During the transition period, Companies that are not yet required to comply with revised Rule 5605(d) and IM-5605-6 must continue to comply with Rule 5605A(d) and IM-5605A-6.

#### **IM-5605-6. Independent Director Oversight of Executive Compensation**

*Independent oversight of executive officer compensation helps assure that appropriate incentives are in place, consistent with the board's responsibility to act in the best interests of the corporation. Compensation committees are required to have a minimum of two members and be comprised only of Independent Directors.*

In addition to satisfying the Independent Director requirements under Rule 5605(a)(2), compensation committee members must not accept any consulting, advisory or other compensatory fee from the Company, other than fees received for board or committee service or fixed amounts of compensation received 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). In addition, a Company's board must consider, in determining whether a director is eligible to serve on the compensation 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. In that regard, while a board may conclude differently with respect to individual facts and circumstances, Nasdaq does not believe that ownership of Company stock by itself, or possession of a controlling interest through ownership of Company stock by itself, precludes a board finding that it is appropriate for a director to serve on the compensation committee. In fact, it may be appropriate for certain affiliates, such as representatives of significant stockholders, to serve on compensation committees since their interests are likely aligned with those of other stockholders in seeking an appropriate executive compensation program.

A Smaller Reporting Company must have a compensation committee with a minimum of two members who are Independent Directors as defined under Rule 5605(a)(2) and a formal written compensation committee charter or board resolution that specifies the committee's responsibilities and authority. However, in recognition of the fact that Smaller Reporting Companies may have fewer resources than larger Companies, Smaller Reporting Companies are not required to adhere to the additional compensation committee eligibility requirements in Rule 5605(d)(2)(A), or to incorporate into their formal written compensation committee charter or board resolution the specific compensation committee responsibilities and authority set forth in Rule 5605(d)(3).

#### **(e) Independent Director Oversight of Director Nominations**

**(1) – (2) No change.**

#### **(3) Non-Independent Committee Member under Exceptional and Limited Circumstances**

Notwithstanding paragraph 5605(e)(1)(B) above, if the nominations committee is comprised of at least three members, one director, who is not [independent]an Independent Director as defined in Rule 5605(a)(2) and is not currently an Executive Officer or employee or a Family Member of an Executive Officer, may be appointed to the nominations committee if the board, under exceptional and limited circumstances, determines that such individual's membership on the committee is required by the best interests of the Company and its Shareholders. A Company that relies on this exception must disclose either on or through the Company's website or in the proxy statement for next annual meeting subsequent to such

determination (or, if the Company does not file a proxy, in its Form 10-K or 20-F), the nature of the relationship and the reasons for the determination. In addition, the Company must provide any disclosure required by Instruction 1 to Item 407(a) of Regulation S-K regarding its reliance on this exception. A member appointed under this exception may not serve longer than two years.

**(4) – (5) No change.**

**IM-5605-7. No change.**

**Rule 5605A. Sunseting Provisions.**

**The provisions of this Rule 5605A shall apply until a Company is subject to the corresponding provisions of Rule 5605.**

**(a) Reserved.**

**(b) Reserved.**

**(c) Reserved.**

**(d) Independent Director Oversight of Executive Officer Compensation**

**(1) Compensation of the chief executive officer of the Company must be determined, or recommended to the Board for determination, either by:**

**(A) Independent Directors constituting a majority of the Board's Independent Directors in a vote in which only Independent Directors participate; or**

**(B) a compensation committee comprised solely of Independent Directors.**

**The chief executive officer may not be present during voting or deliberations.**

**(2) Compensation of all other Executive Officers must be determined, or recommended to the Board for determination, either by:**

**(A) Independent Directors constituting a majority of the Board's Independent Directors in a vote in which only Independent Directors participate; or**

**(B) a compensation committee comprised solely of Independent Directors.**

### **(3) Non-Independent Committee Member under Exceptional and Limited Circumstances**

Notwithstanding paragraphs 5605A(d)(1)(B) and 5605A(d)(2)(B) above, if the compensation committee is comprised of at least three members, one director who is not independent as defined in Rule 5605(a)(2) and is not currently an Executive Officer or employee or a Family Member of an Executive Officer, may be appointed to the compensation committee if the board, under exceptional and limited circumstances, determines that such individual's membership on the committee is required by the best interests of the Company and its Shareholders. A Company that relies on this exception must disclose either on or through the Company's website or in the proxy statement for the next annual meeting subsequent to such determination (or, if the Company does not file a proxy, in its Form 10-K or 20-F), the nature of the relationship and the reasons for the determination. In addition, the Company must provide any disclosure required by Instruction 1 to Item 407(a) of Regulation S-K regarding its reliance on this exception. A member appointed under this exception may not serve longer than two years.

### **IM-5605A-6. Independent Director Oversight of Executive Compensation**

*Independent director oversight of executive officer compensation helps assure that appropriate incentives are in place, consistent with the board's responsibility to maximize shareholder value. The rule is intended to provide flexibility for a Company to choose an appropriate board structure and to reduce resource burdens, while ensuring Independent Director control of compensation decisions.*

\* \* \* \* \*

## **5615. Exemptions from Certain Corporate Governance Requirements**

This rule provides the exemptions from the corporate governance rules afforded to certain types of Companies, and sets forth the phase-in schedules for initial public offerings, Companies emerging from bankruptcy, [and ]Companies transferring from other markets and Companies ceasing to be Smaller Reporting Companies. This rule also describes the applicability of the corporate governance rules to Controlled Companies and sets forth the phase-in schedule afforded to Companies ceasing to be Controlled Companies. During the transition period before Companies are subject to revised Rule 5605(d) and IM-5605-6, a reference in this Rule 5615 to Rule 5605(d) or IM-5605-6 shall be deemed to refer to Rule 5605A(d) or IM-5605A-6.

### **(a) Exemptions to the Corporate Governance Requirements**

#### **(1) Asset-backed Issuers and Other Passive Issuers**

[The following are exempt from the requirements relating to Majority Independent Board [Rule 5605(b)], Audit Committee [Rule 5605(c)], Independent Director Oversight of Executive Officer Compensation [Rule 5605(d)] and Director Nominations [Rule 5605(e)], the Controlled Company Exemption [Rule 5615(c)(2)], and Code of Conduct [Rule 5610]:]The following are exempt from the requirements relating to Majority Independent Board (Rule 5605(b)), Audit Committee (Rule 5605(c)), Compensation Committee (Rule 5605(d)), Director Nominations (Rule 5605(e)), the Controlled Company Exemption (Rule 5615(c)(2)), and Code of Conduct (Rule 5610):

**(A) – (B) No change.**

**IM-5615-1. No change.**

**(2) No change.**

**IM-5615-2. No change.**

**(3) Foreign Private Issuers**

(A) A Foreign Private Issuer may follow its home country practice in lieu of the requirements of the Rule 5600 Series, the requirement to distribute annual and interim reports set forth in Rule 5250(d), and the Direct Registration Program requirement set forth in Rules 5210(c) and 5255, provided, however, that such a Company shall: comply with the Notification of Noncompliance requirement ([ ]Rule 5625), the Voting Rights requirement ([ ]Rule 5640), have an audit committee that satisfies Rule 5605(c)(3), and ensure that such audit committee's members meet the independence requirement in Rule 5605(c)(2)(A)(ii). Except as provided in this paragraph, a Foreign Private Issuer must comply with the requirements of the Rule 5000 Series.

**(B) Disclosure Requirements**

(i) A Foreign Private Issuer that follows a home country practice in lieu of one or more of the Listing Rules shall disclose in its annual reports filed with the Commission each requirement that it does not follow and describe the home country practice followed by the Company in lieu of such requirements. Alternatively, a Foreign Private Issuer that is not required to file its annual report with the Commission on Form 20-F may make this disclosure only on its website. A Foreign Private Issuer that follows a home

country practice in lieu of the requirement in Rule 5605(d)(2) to have an independent compensation committee must disclose in its annual reports filed with the Commission the reasons why it does not have such an independent committee.

(ii) No change.

**IM-5615-3. No change.**

**(4) No change.**

**(5) Management Investment Companies**

Management investment companies (including business development companies) are subject to all the requirements of the Rule 5600 Series, except that management investment companies registered under the Investment Company Act of 1940 are exempt from the Independent Directors requirement, the Compensation Committee requirement, the Independent Director Oversight of [Executive Officer Compensation and] Director Nominations requirement[s], and the Code of Conduct requirement, set forth in Rules 5605(b), (d) and (e) and 5610, respectively. In addition, management investment companies that are Index Fund Shares and Managed Fund Shares, as defined in Rules 5705(b) and 5735, are exempt from the Audit Committee requirements set forth in Rule 5605(c), except for the applicable requirements of SEC Rule 10A-3.

**IM-5615-4. No change.**

**(b) Phase-In Schedules**

**(1) Initial Public Offerings**

A Company listing in connection with its initial public offering shall be permitted to phase in its compliance with the independent committee requirements set forth in Rules 5605(d)(2) and (e)(1)(B) on the same schedule as it is permitted to phase in its compliance with the independent audit committee requirement pursuant to Rule 10A-3(b)(1)(iv)(A) under the Act. Accordingly, a Company listing in connection with its initial public offering shall be permitted to phase in its compliance with the [independent ]committee composition requirements set forth in Rule 5605(d)(2) and (e)(1)(B) as follows: (1) one [independent ]member must satisfy the requirement at the time of listing; (2) a majority of [independent ]members must satisfy the requirement within 90 days of listing; and (3) all [independent ]members must satisfy the requirement within one year of listing. Furthermore, a Company listing in connection

with its initial public offering shall have twelve months from the date of listing to comply with the majority independent board requirement in Rule 5605(b). It should be noted, however, that pursuant to Rule 10A-3(b)(1)(iii) under the Act investment companies are not afforded the exemptions under Rule 10A-3(b)(1)(iv) under the Act. Companies may choose not to adopt a [compensation or ]nomination committee and may instead rely upon a majority of the Independent Directors to discharge responsibilities under Rule 5605(b). For purposes of the Rule 5600 Series other than Rules 5605(c)(2)(A)(ii) and 5625, a Company shall be considered to be listing in conjunction with an initial public offering if, immediately prior to listing, it does not have a class of common stock registered under the Act. For purposes of Rule 5605(c)(2)(A)(ii) and Rule 5625, a Company shall be considered to be listing in conjunction with an initial public offering only if it meets the conditions in Rule 10A-3(b)(1)(iv)(A) under the Act, namely, that the Company was not, immediately prior to the effective date of a registration statement, required to file reports with the Commission pursuant to Section 13(a) or 15(d) of the Act.

**(2) – (3) No change.**

**(4) Phase-In Schedule for a Company Ceasing to be a Smaller Reporting Company**

A Company that has ceased to be a Smaller Reporting Company shall be permitted to phase-in a compensation committee meeting the additional eligibility requirements of Rule 5605(d)(2)(A) relating to compensatory fees and affiliation on the same schedule as Companies listing in conjunction with their initial public offering. Since a Smaller Reporting Company is required to have a compensation committee comprised of at least two Independent Directors, a Company that has ceased to be a Smaller Reporting Company may not use the phase-in schedule for the requirements of Rule 5605(d)(2)(A) relating to minimum committee size or that the committee consist only of Independent Directors. The phase-in schedule will start to run on the due date of the SEC filing in which the Company is required to report that it is an issuer other than a Smaller Reporting Company. During this phase-in schedule, a Company that has ceased to be a Smaller Reporting Company must continue to comply with Rule 5605(d)(5). Within 30 days after the start of its phase-in schedule, a Company that has ceased to be a Smaller Reporting Company must certify to Nasdaq that: (i) it has complied with the requirement in Rule 5605(d)(1) to adopt a formal written compensation committee charter including the content specified in Rule 5605(d)(1)(A)-(D); and (ii) it has, or will within the applicable phase-in schedule, comply with the requirement in Rule 5605(d)(2) regarding compensation committee composition.



**(c) No change.**

**IM-5615-5. No change.**

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