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December 12, 2012

Ms. Elizabeth M. Murphy  
Secretary  
United States Securities and Exchange Commission  
100 F Street, NE  
Washington, DC 20549-1090

Re: Response to Comments  
File No. SR-NASDAQ-2012-109

Dear Ms. Murphy:

The NASDAQ Stock Market LLC (“NASDAQ”) submits this letter in response to comments received by the United States Securities and Exchange Commission (“Commission”) in connection with the above-captioned proposed rule change, which was published in the Federal Register on October 15, 2012.<sup>1</sup> The proposed rule change modifies NASDAQ’s listing rules for compensation committees to comply with Rule 10C-1 under the Securities Exchange Act of 1934, as amended (the “Act”), and make other related changes.

To date, the Commission has received eight comment letters relating to the proposed rule change.<sup>2</sup> Many of the comments were favorable, especially in regards to NASDAQ’s proposals to require a standing compensation committee,<sup>3</sup> to require a formal written compensation

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<sup>1</sup> Securities Exchange Act Release No. 68013 (October 9, 2012), 77 FR 62563 (October 15, 2012) (SR-NASDAQ-2012-109).

<sup>2</sup> The comment letters, which are available at <http://www.sec.gov/comments/sr-nasdaq-2012-109/nasdaq2012109.shtml>, include: (i) Letter from J. Robert Brown, Jr., University of Denver Sturm College of Law, dated October 30, 2012 (the “Brown Letter”); (ii) Letter from Dorothy Donohue, Deputy General Counsel, Securities Regulation, Investment Company Institute, dated November 1, 2012 (the “ICI Letter”); (iii) Letter from Jeff Mahoney, General Counsel, Council of Institutional Investors, dated November 1, 2012 (the “Council Letter”); (iv) Letter from Brandon J. Rees, Acting Director, Office of Investment, AFL-CIO, dated November 5, 2012 (the “AFL-CIO Letter”); (v) Letter from Harold R. Carpenter, CFO, Pinnacle Financial Partners, Nashville, Tennessee, dated November 5, 2012 (the “Pinnacle Letter”); (vi) Letter from Carin Zelenko, Director, Capital Strategies Department, International Brotherhood of Teamsters, dated November 5, 2012 (the “Teamsters Letter”); (vii) Letter from Wilson Sonsini Goodrich & Rosati, P.C. (the “Wilson Sonsini Letter”); and (viii) Letter from Robert B. Lamm, Chair, Securities Law Committee, Society of Corporate Secretaries and Governance Professionals, New York, New York, dated December 7, 2012 (the “Society Letter”).

<sup>3</sup> See the Brown and Council Letters.

committee charter<sup>4</sup> and to exempt management investment companies from the proposals.<sup>5</sup> Below NASDAQ responds to broad themes from the comment letters relating to: (i) compensatory fees, (ii) affiliation, (iii) other independence factors, (iv) the exceptional and limited circumstances exception and (v) compensation committee responsibilities and authority. Capitalized terms in this letter have the meanings assigned to such terms in NASDAQ's Listing Rules.

## **I. Compensatory Fees**

In response to Rule 10C-1's requirement that it consider compensatory fees in determining the independence requirements for compensation committee members, NASDAQ proposed to prohibit a compensation committee member from accepting directly or indirectly any consulting, advisory or other compensatory fee from the Company or any subsidiary thereof. Two commenters objected to this prohibition on the grounds that it is unnecessarily prescriptive and effectively precludes certain directors from compensation committee service.<sup>6</sup>

In developing its proposal, NASDAQ carefully weighed the potential benefits and burdens of the prohibition. NASDAQ determined that the payment of direct or indirect fees from a Company to a compensation committee member could influence, or create the appearance of influencing, the member's judgment and therefore render the member unwilling or unable to provide a truly independent voice on executive compensation decisions. NASDAQ acknowledges that the prohibition will preclude certain professionals from compensation committee service. However, given the heightened importance of executive compensation decisions in today's business environment, NASDAQ believes that the goal of ensuring independent compensation decisions outweighs the potential negative impact of excluding a small group of individuals from compensation committee service.

While other commenters generally supported the proposed ban on compensatory fees, some also argued that director fees are a form of compensation and boards should consider such fees when determining the independence of compensation committee members.<sup>7</sup> As NASDAQ stated in its proposal, it does not believe the intent of Section 10C of the Act or Rule 10C-1 was to limit independence based on director compensation. Companies typically adopt a uniform compensation policy that applies to all directors, not just those on the compensation committee, so a requirement to determine eligibility for compensation committee service based on director

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<sup>4</sup> See the Council Letter.

<sup>5</sup> See the ICI Letter.

<sup>6</sup> See the Pinnacle and Society Letters. The Pinnacle Letter also objected that NASDAQ did not solicit public comments on the proposed rule change. NASDAQ did not independently solicit public comments because it filed its proposal under Section 19(b) of the Act, which requires the Commission to publish the proposal in the Federal Register for public comments. This is consistent with the standard practice of NASDAQ and other self-regulatory organizations for soliciting comments on proposed rule changes.

<sup>7</sup> See the Brown, AFL-CIO and Teamsters Letters.

fees would lead to no meaningful distinction among directors. In addition, NASDAQ believes that directors should be adequately compensated to ensure they devote appropriate time and attention to their roles and responsibilities, which continue to increase in today's complex environment. Moreover, to the extent a conflict of interest exists because directors set their own compensation, Companies must disclose director compensation, and investors will become aware of excessive or non-customary director compensation through this means. Finally, as discussed below, a board 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. If appropriate, a board could consider director fees in this context.

## **II. Affiliation**

One commenter believed that NASDAQ's proposal should extend to compensation committee members the ban on being an "affiliated" person of a Company or its subsidiaries that applies to audit committee members under Rule 10A-3(b)(1) of the Act.<sup>8</sup> As NASDAQ explained in its proposal, it did consider whether to adopt such a prohibition, but ultimately concluded that such a blanket prohibition would be inappropriate for compensation committee members. For example, it may be desirable for representatives of significant stockholders to serve on compensation committees since their interests are aligned with other stockholders in seeking a rational compensation program. NASDAQ notes that the Commission received many letters supporting this position in response to its solicitation of comments on proposed Rule 10C-1.<sup>9</sup>

## **III. Other Independence Factors**

Some commenters believed that NASDAQ should adopt additional independence factors for compensation committee service, beyond the proposed factors relating to compensatory fees and affiliation. For example, some commenters suggested that boards should consider business or personal relationships between directors and executive officers in determining the independence of those serving on the compensation committee.<sup>10</sup> Other commenters recommended that the relevant factors should include related party transactions that are required to be disclosed under Item 404(a) of Regulation S-K.<sup>11</sup>

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<sup>8</sup> See the Teamsters Letter.

<sup>9</sup> See Securities Exchange Act Release No. 67220 (June 20, 2012), 77 FR 38422, 38427 (June 27, 2012) (the "Adopting Release"). See also the Council Letter ("The Council does not object to the Proposed Rule's change to the current listing standards to require 'that Companies' boards of directors should consider affiliation in making an eligibility determination for compensation committee members, but . . . not propose bright-line rules around this factor.'")

<sup>10</sup> See the Brown, Council, AFL-CIO and Teamsters Letters.

<sup>11</sup> See the AFL-CIO and Teamsters Letters.

Under both its current and proposed rules, NASDAQ requires that compensation committee members must be Independent Directors.<sup>12</sup> As NASDAQ explained in detail in its proposal, the definition of the term Independent Director includes a two-part test for independence.<sup>13</sup> First, there are certain categories of directors who cannot be considered independent, and second, the board 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. This bifurcation recognizes that NASDAQ cannot in its rules legislate every possible relationship between a Company and its directors and therefore empowers the board, which must be comprised of a majority of Independent Directors, to assess the relevant relationships.

Several commenters advocated that NASDAQ should clarify that a single factor can result in the loss of director independence.<sup>14</sup> As stated in its proposal, NASDAQ confirms that a director cannot be independent if he or she fails any of the bright-line prohibitions in the definition of Independent Director. In addition, a director cannot serve on the compensation committee if he or she accepts directly or indirectly any consulting, advisory or other fee from the Company or any subsidiary thereof. NASDAQ's proposals operate to exclude directors who fail these tests from serving on the compensation committee, and NASDAQ does not believe it is necessary to provide further clarification on these points.

#### **IV. Exceptional and Limited Circumstances Exception**

Some commenters objected to NASDAQ's retention of the exceptional and limited circumstances exception,<sup>15</sup> which allows one non-Independent Director to serve on the compensation committee for up to two years. 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 must disclose its use of the exception. NASDAQ proposed to allow a Company to avail itself of this exception even for a director who fails the new requirements adopted pursuant to Rule 10C-1 relating to compensatory fees and affiliation. This proposal is consistent with Rule 10C-1, which explicitly permits a national securities exchange to exempt from these requirements "a particular relationship with respect to members of the compensation committee, as each national securities

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<sup>12</sup> See current and proposed NASDAQ Listing Rule 5605(d).

<sup>13</sup> See NASDAQ Listing Rule 5605(a)(2).

<sup>14</sup> See the Brown, AFL-CIO and Teamsters Letters.

<sup>15</sup> See the Brown, Council and AFL-CIO Letters.

exchange ... determines is appropriate, taking into consideration the size of an issuer and any other relevant factors.”<sup>16</sup>

NASDAQ’s rules have included the exceptional and limited circumstances exception for compensation committees since NASDAQ implemented rules regarding independent director oversight of executive officer compensation in 2003.<sup>17</sup> The exception has been used, though infrequently, throughout its life, and therefore, NASDAQ believes it adds value to the rules on compensation committees. In NASDAQ’s opinion, it is appropriate to allow a Company some flexibility as to board and committee membership and composition under exceptional and limited circumstances. This is particularly important for a smaller Company that may have relationships that require such flexibility. In this way the exception also addresses concerns raised by some commenters that the proposal to prohibit a compensation committee member from accepting directly or indirectly any consulting, advisory or other compensatory fee from the Company is overly prescriptive.<sup>18</sup>

One commenter specifically worried that “as currently phrased, a board could include on the compensation committee a non-independent director indefinitely.”<sup>19</sup> NASDAQ is unaware of any Company that has abused the use of the exception. Companies must publicly disclose any reliance on the exception, so NASDAQ, as well as investors, would be made aware of any serial use of the exception. Finally, NASDAQ tracks the use of the exception by Companies, and NASDAQ could exercise its discretionary authority to “apply additional or more stringent criteria for the initial or continued listing of particular securities” and deny use of the exception to any Company that NASDAQ believed was abusing it.<sup>20</sup>

## **V. Compensation Committee Responsibilities and Authority**

One commenter suggested that proposed NASDAQ Listing Rule 5605(d)(3), which relates to certain compensation committee responsibilities and authority, would benefit from clarification.<sup>21</sup> Specifically, the commenter stated that as it relates to outside legal counsel, the proposed rule “could be read to require a compensation committee ... to consider the independence factors set forth in Rule 10C-1(b)(4)(i)-(vi) only when selecting independent counsel, rather than any outside legal counsel that might provide legal advice to a compensation committee.” The intent of Rule 10C-1(b)(4)(i)-(vi) is to require compensation committees to consider the independence factors when selecting *any* compensation consultant, legal counsel or

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<sup>16</sup> See Rule 10C-1(b)(1)(iii)(B).

<sup>17</sup> See Securities Exchange Act Release No. 48745 (November 4, 2003), 68 FR 64154 (November 12, 2003).

<sup>18</sup> See the Pinnacle and Society Letters.

<sup>19</sup> See the Brown Letter.

<sup>20</sup> See NASDAQ Listing Rule 5101.

<sup>21</sup> See the Wilson Sonsini Letter.

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other compensation adviser, other than in-house legal counsel.<sup>22</sup> NASDAQ is filing an amendment to its proposal to, among other things, clarify this point.

As stated in its proposal, 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. More specifically, and as stated by the Commission, a “compensation committee may receive advice from non-independent counsel, such as in-house counsel or outside counsel retained by management, or from a non-independent compensation consultant or other adviser, including those engaged by management.”<sup>23</sup>

## **VI. Conclusion**

For all of the foregoing reasons, and as further explained in its proposed rule change, NASDAQ believes its proposal is consistent with the Act and requests approval of the proposal by the Commission. Please feel free to call me at the above number if you have any questions concerning this matter.

Sincerely,

A handwritten signature in black ink that reads "Erika J. Moore". The signature is written in a cursive, slightly slanted style.

Erika J. Moore

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<sup>22</sup> See the Adopting Release, at 38433 (stating that “This instruction will not affect the obligation of a compensation committee to consider the independence of outside legal counsel or compensation consultants or other advisers retained by management or by the issuer. We believe that information gathered from an independence assessment of these categories of advisers will be useful to the compensation committee as it considers any advice that may be provided by these advisers. In addition, excluding outside legal counsel or compensation consultants retained by management or by the issuer from the required independence assessment may not be competitively neutral, since, as some commentators pointed out, they often perform the same types of services as the law firms and compensation consultants selected by the compensation committee.”)

<sup>23</sup> Id. at 38430.