

## Considerations for Placing Private Equity Sponsor Representatives on Public Portfolio Company Board Committees

Many private equity sponsors have been or are considering undertaking an initial public offering of a portfolio company. In negotiating stockholder arrangements and committee assignments for their director representatives after a portfolio company completes an IPO, sponsors should consider recently adopted changes to stock exchange listing rules that affect committee membership and other rules promulgated under the Securities Exchange Act of 1934, as amended (“Exchange Act”), that may affect the ability of sponsor-nominated directors to serve on certain board committees or to satisfy the independence standards imposed by the stock exchanges.

For a listed company that is not a controlled company (that is, more than 50% of the company’s voting power for the election of directors are held by an individual, group or another company), both the New York Stock Exchange (“NYSE”) and Nasdaq require that the board of directors consist of a majority of independent directors. More stringent independence standards apply to service on the audit committee and, upon effectiveness of the recently adopted changes to the NYSE and Nasdaq listing rules, to service on the compensation committee of issuers that are not controlled companies.

### *Audit Committee*

- Each of the NYSE and Nasdaq has adopted independence requirements for audit committee members in accordance with Rule 10A-3 under the Exchange Act. Under each standard, an independent director must not accept directly or indirectly any consulting, advisory or other compensatory fees from the issuer or any subsidiary thereof, or be an affiliated person of the issuer.
  - In contrast with the independence requirements relating to compensation committees described below, share ownership that would make a director or a director’s affiliate an “affiliated person” of the issuer would disqualify that director from being able to serve as an audit committee member.
- IPO phase-in periods. A newly public company listed on either the NYSE or Nasdaq must have at least one independent director on the audit committee at the time of the IPO, must have a majority independent audit committee within 90 days of the pricing of the IPO, and must have a fully independent audit committee within one year of pricing of the IPO.

### *Compensation Committee*

- Exchange Act Rule. Rule 10C-1 under the Exchange Act requires the national securities exchanges to impose listing rules that require each member of the listed company’s compensation committee to be independent.
- NYSE-listed companies. The NYSE will not impose a bright line test on the independence determination for the compensation committee. The board must affirmatively determine the independence of any compensation committee member and, in doing so, consider all factors relevant to determining whether a director has a relationship with the company that is material to that director’s ability to be independent from management in connection with the duties of a compensation committee member. The board should consider, among other things, (i) the sources of

compensation of such director and (ii) whether such director is affiliated with the listed company, a subsidiary of the listed company or an affiliate of a subsidiary of the listed company.

- In its adopting release, the NYSE indicated it did not intend to adopt an absolute prohibition on a board making a determination that a director is independent where the director or any of the director's affiliates are shareholders owning in excess of some percentage of a listed company. Rather than adversely affecting a director's ability to be independent as a compensation committee member, the NYSE believes that share ownership aligns the director's interests with those of unaffiliated shareholders because share ownership should produce the same economic interest in ensuring that executive compensation is not excessive.
- Nasdaq-listed companies. Nasdaq's bright line test requires that each compensation committee member must not accept any consulting advisory or other compensatory fees from the company other than fees for board service or under a retirement plan for prior service with the company. In determining independence, the Board must consider whether a director is affiliated with the company, a subsidiary of the company, or an affiliate of a subsidiary of the company to determine whether any such affiliation would impair the director's judgment.
  - In the adopting release, Nasdaq indicated that it does not believe that the 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's appropriate for a director to serve on the compensation committee. In addition, the Nasdaq release indicated that it may be appropriate for certain affiliates such as representatives of significant stockholders to serve on compensation committees because their interests are likely aligned with those of other stockholders.
- Effectiveness – Nasdaq- and NYSE-listed companies will have until the earlier of the first annual meeting after January 15, 2014 or October 31, 2014 to comply with the independence standards.
- Rule 16b-3. Typically, the compensation committee of a public company will be tasked with administering the company's equity plans and approving awards. Under Rule 16b-3 of the Exchange Act, transactions with the issuer, such as equity award grants, can be deemed an exempt transaction from the Section 16 short-swing profit rules if approved by a committee of non-employee directors. A non-employee director is a director who is not currently an officer of the issuer or currently employed by a subsidiary or a parent of the issuer, and who does not receive compensation, either directly or indirectly from the issuer or a parent or subsidiary of the issuer. Sponsor-nominated directors may not qualify as outside directors if funds affiliated with the private equity sponsor own a large enough stake (not necessarily a majority) in the company to be deemed a "parent" of the issuer under applicable rules and interpretations.
- IPO phase-in periods. A newly public company listed on either the NYSE or Nasdaq must have at least one independent director on the compensation committee at the time of the IPO, must have a majority independent compensation committee within 90 days of the pricing of the IPO, and must have a fully independent compensation committee within one year of pricing of the IPO. There is no phase-in for Section 16 compliance.

A private equity sponsor nominating directors to the board of a public portfolio company should consider the following common circumstances, among others, when nominating an independent director. In addition, these circumstances should be disclosed to other members of the board:

- Whether the company currently pays, or has in the most recent three-year period, paid management or other transaction fees to the private equity sponsor or an affiliated management company and, in order to determine whether management fees may be attributable to the director, whether the director is an employee or partner of a management entity that collects management fees from the company or is otherwise employed by the private equity sponsor to determine whether management fees may be attributable to the director.
- Whether the private equity sponsor holds a sufficient quantity of company shares to be deemed an affiliate under the securities laws (defined for this purpose to mean ownership of greater than 10% of any class of voting equity security of the company).
- For purposes of determining whether the company will qualify for controlled company exceptions to the majority board independence and compensation committee independence requirements, whether the company is controlled by the private equity sponsor, or a group including the private equity sponsor (more than 50% owned).

If you have questions about the rules described above, please contact any member of Ropes & Gray's [securities & public companies](#) or [private equity](#) practice groups or your usual Ropes & Gray adviser.