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SEC Approves NYSE and Nasdaq Listing Standards For Compensation Committees and Their Advisors

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On January 11, 2013, the Securities and Exchange Commission (the “SEC”) approved amendments to the listing standards of each of the New York Stock Exchange (the “NYSE”) and the NASDAQ Stock Market (“Nasdaq”). The amendments implement the SEC’s final rules (the “Final Rules”) on the independence of compensation committees and their selection of advisors pursuant to Rule 952 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010.¹ The final listing standards were adopted substantially as proposed by the exchanges in September 2012.²

Notable provisions in the NYSE and Nasdaq listing standards include the following:

- Nasdaq significantly enhanced its listing requirements regarding the composition of compensation committees and now will, like the NYSE, require listed companies to (i) have a standing compensation committee consisting of at least two independent

¹ See 17 C.F.R. 240.10C-1. For a discussion of the Final Rules, see our client publication “SEC Issues Final Rules on Independence of Compensation Committees and Their Advisors,” available at <http://www.shearman.com/sec-issues-final-rules-on-independence-of-compensation-committees-06-26-2012/>.

² For a discussion of the listing standards as originally proposed, see our client publication “The NYSE and Nasdaq Issue Proposed Rules to Implement the SEC Compensation Committee Independence and Advisor Rules,” available at <http://www.shearman.com/the-nyse-and-nasdaq-issue-proposed-rules-to-implement-the-sec-compensation-committee-independence-and-advisor-rules-10-04-2012/>. The NYSE amended its proposal on each of October 2, 2012, and January 8, 2013 and Nasdaq amended its proposal on each of December 12, 2012 and January 1, 2013.

directors and (ii) adopt a formal, written compensation committee charter specifying certain responsibilities and authority;

- Nasdaq partially harmonizes the compensation committee director independence criteria with those of the audit committee and therefore prohibits independent compensation committee members from accepting, directly or indirectly, any consulting, advisory or other compensatory fee from the listed company or its subsidiaries;
- The NYSE added an additional test for director independence that requires the board to consider all factors relevant to determining whether the director has a relationship that is material to the director's ability to be independent from management; and
- Neither exchange added to the six factors the SEC identified for evaluating advisor independence.

Effective Dates

Nasdaq. Nasdaq rules relating to the compensation committee's (i) retention, compensation, oversight and funding of advisors and (ii) requirement to analyze advisor independence will be effective on July 1, 2013.³ Compliance with the remaining provisions will be required by the earlier of: (1) the listed company's first annual meeting after January 15, 2014 or (2) October 31, 2014. Companies must certify compliance with the applicable requirements no later than 30 days after the applicable implementation deadline. The form of certification will be available through Nasdaq's Listing Center website prior to the effective date of the Nasdaq rules.

NYSE. The NYSE rules will generally be effective July 1, 2013. However, with respect to the compensation committee independence requirements, listed companies will have until the earlier of: (i) their first annual meeting after January 15, 2014 or (ii) October 31, 2014, to comply.

Compensation Committee Composition

Nasdaq. Nasdaq's amended standards require listed companies to have a compensation committee consisting of at least two "independent" directors (as determined in accordance with the rules described below) to determine the compensation of the company's executive officers. Current rules provide that executive officer compensation can be determined by either (i) a committee consisting of one or more independent directors or (ii) a majority of the independent directors of the board. Although this modification was not required pursuant to the Final Rules, Nasdaq indicated that there are benefits to a board having a standing committee on executive compensation, including the committee's development of expertise regarding the company's compensation programs and promoting accountability to shareholders for executive compensation decisions. Moreover, given the importance of compensation decisions to shareholders, Nasdaq believes that it is appropriate to require that more than one director be responsible for these decisions.

³ To the extent a listed company does not have a compensation committee in the period before the final implementation deadline applicable to it, the provisions of the rule will 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.

NYSE. The NYSE already requires a standing compensation committee consisting of independent directors but does not dictate a minimum number of required members.⁴ Beginning with the effective date of the new standards, independence of compensation committee members will be determined as described below.

Compensation Committee Director Independence Standards

The Final Rules direct the securities exchanges to adopt independence requirements for compensation committee members, taking into account the following factors: (i) the source of the director's compensation, including any consulting, advisory or other compensatory fees paid by the listed company and (ii) whether the director has an affiliate relationship with the company, a subsidiary of the company or an affiliate of a subsidiary of the company. Neither the new NYSE nor the Nasdaq listing standards include any additional factors to be considered.

Nasdaq. Prior to the amendments, the Nasdaq rules set forth a two part test to determine director independence generally. First, certain categories of directors may not be considered independent⁵ and, second, the board must make an affirmative determination that the independent director does not have a relationship that would interfere with the exercise of independent judgment in carrying out his or her responsibilities. For directors proposed for compensation committee membership, the amended listing standards enhance the general provisions by characterizing as *not* independent (and hence not eligible for compensation committee service), directors who receive any (rather than, as under the general Nasdaq rules, more than a threshold amount of) consulting, advisory or other compensatory fee from the listed company.⁶ The enhanced standard applicable to compensation committees conforms to the existing Nasdaq requirements for audit committee independence, except that there is no "look back" period for this prohibition (as is the case for the audit committee independence standards); it begins with the director's commencement of service on the compensation committee.⁷

⁴ NYSE Listed Company Manual, Section 303A.05.

⁵ These include: (i) an executive officer of the company, (ii) a director who is or was in the past three years employed by the company, (iii) a director who accepted or had a family member who accepted compensation from the company exceeding \$120,000 during any period of 12 consecutive months within the three years preceding the independence determination, (iv) a director who is a family member of an individual who is or was in the past three years an executive officer of the company, (v) a director who is, or has a family member who 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 years that exceed the greater of 5% of the recipient's gross revenues for that year or \$200,000, (vi) a director of the company who is, or who has a family member who is, an executive officer of another entity where at any time during the prior three years any of the executive officers of the company serve on the compensation committee of the other entity or (vii) 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 the prior three years.

⁶ The Nasdaq rules permit a compensation committee member to (i) receive fees for membership on the board or any board committee and (ii) fixed amounts of compensation under a retirement plan for prior service with the company, provided that such compensation is not contingent in any way on continued service.

⁷ The Nasdaq rule retains an existing exception allowing a company to have a non-independent director serve on the compensation committee under exceptional and limited circumstances. Under this exception, if a compensation committee is comprised of at least three members, one director who is not independent may serve as a committee member for up to two years, provided that such individual is not an executive officer or

NYSE. NYSE rules also provide for a two part independence determination test for directors generally. First, if a director has a relationship with a listed company that violates one of five listed “bright line” tests,⁸ he or she is deemed not to be independent. Second, no director qualifies as “independent” unless the board of directors affirmatively determines that the director has no material relationship with the listed company (either directly, or as a partner, shareholder or officer of an organization that has a relationship with the company). For directors proposed for compensation committee service, the NYSE’s amended listing standards require, in addition, that a board consider “all factors specifically relevant to determining whether a director has a relationship” to the listed company that is “material to the director’s ability to be independent from management,” including the two factors specified in the Final Rules. In contrast to Nasdaq, the NYSE’s listing standards do not create an outright prohibition for members of the compensation committee to receive compensation from the listed company.

Interestingly, neither the NYSE nor Nasdaq adopted specific standards prohibiting individuals with affiliate relationships from serving on the compensation committee as long as such relationships are considered as part of the independence evaluation. Rather, they noted that it may be appropriate for certain affiliates, such as significant shareholders, to serve on compensation committees as their interests are likely to be aligned with other shareholders in ensuring appropriate executive compensation.

Compensation Committee Advisors

Under the Final Rules, the NYSE’s and Nasdaq’s listing standards must require that compensation committees have (i) the direct responsibility for the appointment, compensation and oversight of the work of any compensation consultants, independent legal advisors⁹ and other compensation advisors retained by the compensation committee, and

an immediate family member of an executive officer, if the board determines that such individual’s membership on the committee is required by the best interests of the company. In this instance, disclosure is required on the company’s website or the next proxy statement.

⁸ The tests are: (i) the director is, or has been within the last three years, an employee of the listed company, or an immediate family member is, or has been within the last three years, an executive officer, of the listed company, (ii) the director has received, or has an immediate family member who has received, during any-12 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), (iii) (A) the director is a current partner or employee of a firm that is the listed company’s internal or external auditor, (B) the director has an immediate family member who is a current partner of such a firm, (C) the director has an immediate family member who is a current employee of such a firm and personally works on the listed company’s audit or (D) the director or an immediate family member was within the last three years a partner or employee of such a firm and personally worked on the listed company’s audit within that time, (iv) the director or an immediate family member is, or has been within the last three years, employed as an executive officer of another company where any of the listed company’s present executive officers at the same time serve on that company’s compensation committee or (v) the director is a current employee, or an immediate family member is a current executive officer, of a company that has made payments to, or received payments from, the listed company for property or services in an amount which, in any of the last three fiscal years, exceeds the greater of \$1 million, or 2% of such other company’s consolidated gross revenues.

⁹ The final Nasdaq listing standards removed the references to “independent” legal advisors set forth in the Final Rules noting that the independence considerations apply to any legal counsel other than in-house counsel. While the NYSE has not made a conforming change, in response to a comment letter, it clarified that a compensation committee must evaluate the independence of any outside legal counsel prior to selection or the provision of advice.

(ii) the authority to retain, or obtain the advice of, such advisors. Companies are required to provide adequate funding to pay the advisors. In addition, compensation committees may select an advisor (other than in-house counsel) only after taking into consideration six specified independence factors¹⁰ (as well as any additional factors specified by the exchange).

Both the NYSE and Nasdaq amended listing standards generally adopt the provisions as set forth in the Final Rules. Although the SEC invited the exchanges to add to the list of factors, neither Nasdaq nor the NYSE elected to do so. Nasdaq clarified that companies are required to consider only the six specified factors when evaluating advisor independence. The NYSE rules provide, however, that compensation committees must consider all factors relevant to an advisor's independence, including the six factors.

The Nasdaq amendments also require that the six independence factors be considered when selecting, *or receiving advice from*, a compensation advisor (emphasis added) clarifying that the analysis cannot be circumvented by simply not "*selecting*" an advisor. While the text of the NYSE rules does not require an independent evaluation prior to "*receiving advice*" from an advisor, the commentary provides that the compensation committee should consider the factors before "*selecting or receiving advice*" from an advisor. Neither the NYSE or the Nasdaq provides guidance on the circumstances under which a compensation committee will be considered to "*receive*" advice from a consultant or other advisor it has not "*selected*".

Both the NYSE and Nasdaq rules expressly provide that a compensation committee is not required to conduct an independence assessment of an advisor whose role is limited to (i) consulting on any broad-based plan that does not discriminate in scope, terms or operation, in favor of executive officers or directors, and that is available generally to all salaried employees or (ii) providing information that either is not customized or that is customized based on parameters that are not developed by the advisor, and about which the advisor does not provide advice. This language parallels the requirements of Item 407(e)(3)(iii) of Regulation S-K, which provides a limited exception to the SEC's requirement that a company disclose any role of a compensation consultant in determining or recommending the amount and form of a registrant's executive and director compensation.

Neither the Final Rules nor the listing standards require that a compensation advisor actually be independent, but only that the committee consider the six factors when selecting or seeking advice from a given advisor. A compensation committee may select or receive advice from any advisor it prefers, including those that are not independent. Further, compensation committees are not required to follow the advice of or recommendations from any of its advisors, and the rules may not be construed to affect the compensation committee's ability or obligation to exercise its own judgment.

¹⁰ These factors include: (i) whether the compensation consulting company employing the compensation advisor is providing any other services to the company, (ii) how much the compensation consulting company who employs the compensation advisor has received in fees from the company, as a percentage of that person's total revenue, (iii) what policies and procedures have been adopted by the compensation consulting company employing the compensation advisor to prevent conflicts of interest, (iv) whether the compensation advisor has any business or personal relationship with a member of the compensation committee, (v) whether the compensation advisor owns any stock of the company and (vi) whether the compensation advisor or the person employing the advisor has any business or personal relationship with an executive officer of the company.

Compensation Committee Charters

Nasdaq. Prior to the amended listing standards, Nasdaq did not require listed companies to adopt a written compensation committee charter. The final listing standards require each listed company to certify that it has adopted a formal written compensation committee charter and that the committee will review and reassess the charter's adequacy annually. The charter must specify:

- The scope of the compensation committee's responsibilities and how it carries them out (including structure, processes and membership requirements);
- The committee's responsibility for determining, or recommending to the board for determination, the compensation of the chief executive officer and the other executive officers;
- That the chief executive officer may not be present during voting or deliberations on his or her compensation; and
- The committee's authority regarding its advisors as described in the preceding section.

Listed companies must certify that they have timely adopted a charter and that they will review and assess the adequacy of the charter on an annual basis.¹¹

NYSE. The NYSE requires compensation committees to have a written charter. The amended listing standards add that the charter must contain the rights and duties relating to compensation committee advisors described above.

Cure Periods

The SEC directed the exchanges to provide listed companies with an opportunity to cure non compliance with any of the Final Rules. The SEC also provided that if a compensation committee member ceased to be independent for a reason outside of his reasonable control, the member, on notice by the company to the exchange, could remain on the committee until the earlier of the next annual meeting or one year from the occurrence of the event causing him or her to cease being independent.

Nasdaq. Nasdaq's amended listing standards allow companies additional time in the event the non-compliance occurs less than 180 days prior to the next annual meeting, in which case, the company would have 180 days from the event to cure. Any company relying on this rule must notify Nasdaq immediately upon learning of the event or circumstance that caused the non-compliance.

NYSE. The NYSE's standards would limit the ability to cure to circumstances where the compensation committee continues to have a majority of independent directors. The NYSE indicates that this requirement would address any actual or apparent conflict of interest resulting from a non independent director's service on the compensation committee. A company relying on the cure period must promptly notify the NYSE.

¹¹ Nasdaq also requires a formal written charter for the audit committee and requires that the charter state that the audit committee "has reviewed and reassessed" the adequacy of the charter on an annual basis. The amended listing standards also amend this requirement for the audit committee to make it prospective, rather than retrospective, to conform to the compensation committee rules.

Foreign Private Issuers

The Final Rules exempt a foreign private issuer from the independent compensation committee requirements if it discloses in its annual report the reasons it does not have an independent compensation committee. Foreign private issuers would be subject to the compensation advisor rules unless the exchanges elect to exempt them.

Nasdaq. Nasdaq expands the Final Rules to exempt foreign private issuers that follow their home country corporate governance practices from both the compensation committee independence and advisor rules, provided that the foreign private issuer discloses each Nasdaq listing requirement that it does not follow and describes its applicable home country practice. If a foreign private issuer follows its home country practice and does not have an independent compensation committee, it must also disclose the reasons why it does not.

NYSE. The NYSE also exempts foreign private issuers that follow their home country corporate governance practices from both the compensation committee independence and advisor rules, provided that the foreign private issuer discloses the significant ways in which its corporate governance practices differ from those followed by domestic listed companies. Accordingly, any foreign private issuer seeking to avail itself of the exemption afforded by the amended listing standards rules would need to disclose the differences in its corporate governance practices from the domestic company requirements. Disclosure of the reasons for these differences is not required, however, as the NYSE noted that, most frequently, foreign private issuers would merely be stating that home country law has no similar requirement.

Exemptions

The Final Rules exempted controlled companies from the entirety of the compensation committee and advisor requirements. Other entities were also exempted from the compensation committee independence requirements (i.e., limited partnerships, companies in bankruptcy and open end management investment companies registered under the Investment Company Act of 1940 (the “1940 Act”). The Final Rules granted discretion to the exchanges to exempt certain other categories of companies. Each of the NYSE and Nasdaq has adopted rules applying their existing exemptions to the new requirements.

Nasdaq. Nasdaq’s requirements will also not apply to asset backed companies and other passive companies, cooperatives, limited partnerships, registered management investment companies, closed end funds or companies, such as unit investment trusts or other unincorporated associations that do not have a board of directors or people acting in a similar capacity and whose activities are limited to passively owning or holding securities or other assets on behalf of or for the benefit of the holders of the listed securities.

NYSE. The NYSE amendments exempt limited partnerships, companies in bankruptcy proceedings and open end management investment companies from all of the requirements. These entities are generally exempt from the existing NYSE compensation committee requirements. The NYSE’s requirements will also not apply to closed end funds registered under the 1940 Act, passive companies and companies whose only listed equity security is preferred stock. The NYSE indicates that these categories of companies are typically (i) externally managed and tend not to directly employ executives, (ii) do not by their nature have employees or (iii) have executive compensation policy set by a body other than the board, and requiring them to establish compensation committees would be unduly burdensome.

Smaller Reporting Companies

Smaller Reporting Companies are exempt from all of the requirements under the Final Rules.

Nasdaq. Under the Nasdaq rules, a smaller reporting company is generally exempt from the compensation committee and advisor requirements but must certify that it has a compensation committee comprised of at least two independent directors and that it has adopted a formal written compensation committee charter or board resolution having the same effect. The requirements to specify that the compensation committee has authority to retain advisors, the right to receive funding for advisors and the responsibility to consider independence before selecting those advisors is not required to be in the charter. Nasdaq's amended listing standards provide for a phase in schedule applicable for listed companies that cease to be smaller reporting companies.

NYSE. The NYSE listing standards exempt smaller reporting companies from compliance with the enhanced independence factors for members of the compensation committee and the obligation to consider the independence factors prior to selecting advisors. These entities will continue to be subject to the rules regarding the compensation committee's authority, responsibility and funding of compensation advisors. As a result, smaller reporting companies will effectively be subject to the same requirements as is currently the case under existing rules. The NYSE's amended listing standards provide for a phase in schedule applicable for listed companies that cease to be smaller reporting companies.

Next Steps

Listed companies that are subject to the amended listing standards should begin to take action to comply with these rules. In particular:

- Compensation committee charters should be reviewed, and revised as necessary, to ensure that the compensation committee is provided the powers and authorities articulated in the Final Rules and the amended listing standards. Although not a required element of the charter under the Nasdaq or NYSE standards, companies should consider adding to the charter a requirement that the compensation committee carry out the required advisor independence assessments. NYSE listed companies must have a compliant charter in place by July 1, 2013. Nasdaq listed companies generally must adopt a compliant charter by the earlier of (i) the first annual meeting after January 15, 2014 or (ii) October 31, 2014 to comply; however, any Nasdaq company that does not have a compliant charter in place by July 1, 2013 should adopt a board resolution providing the compensation committee with the authority and responsibilities with respect to advisors.
- Implement new procedures or revise existing procedures to reflect the new compensation committee independence standards. This will likely include amendments to the company's D&O questionnaire.

- Implement new procedures or revise existing procedures related to the evaluation of compensation committee advisor independence. The evaluation should be done prior to selecting or receiving advice from a new advisor and at least annually thereafter. In order to ensure a consistent basis for analyzing advisor independence, companies should consider developing a questionnaire that all advisors (other than in-house counsel) will be required to complete and that will elicit the information relevant to the independence assessment.¹² Information and representations obtained from an advisor can be used as the basis of the committee's analysis, but should not replace the committee's independent assessment and independence determination.
- Nasdaq-listed companies that do not already have a compensation committee must establish one by the earlier of (i) the first annual meeting after January 15, 2014 or (ii) October 31, 2014 to comply.
- As a reminder, any proxy statement for an annual meeting occurring on or after January 1, 2013 must include a disclosure of any conflicts of interest arising as the result of the engagement of compensation consultants (but not other advisors). The instruction to item 407(e)(3)(iv) states that the six factors relevant to consultant independence should be considered in determining whether a conflict of interest exists. If not yet completed, all listed companies should conduct a conflicts analysis to prepare for this disclosure. It should be noted that the disclosure requirement is an obligation of the company, whereas the assessment of compensation consultant independence is required to be conducted by the compensation committee. Companies should consider procedures that will enable the company to benefit from the compensation committee's analysis for purposes of determining whether any conflict disclosure is required.

¹² Some advisors may prefer to furnish the company with a letter analyzing their relationship with the company under each of the six factors. While this approach is acceptable in principle, a standard form of questionnaire provided by the company should facilitate the committee's task and seems better calibrated to ensure that independence standards are applied consistently.