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The NYSE and Nasdaq Issue Proposed Rules to Implement the SEC Compensation Committee Independence and Advisor Rules

On September 25, 2012, each of the New York Stock Exchange (the “NYSE”) and the NASDAQ Stock Market (“Nasdaq”) filed proposed changes to their listing standards.¹ The proposed changes are in response to the final rules issued by the Securities and Exchange Commission (the “SEC”) on June 20, 2012 (the “Final Rules”),² directing the national securities exchanges to adopt listing standards relating to 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 2010.³ While the proposed listing standards largely reflect the Final Rules, they contain some deviations from the Final Rules and from each other. Notable provisions in the NYSE and Nasdaq proposals include the following:

- Nasdaq significantly enhanced its listing requirements regarding compensation committees and now will, like the NYSE, require listed companies to (i) have a standing compensation committee consisting of at least two independent directors and (ii) adopt a formal, written compensation committee charter specifying certain responsibilities and authority;
- Nasdaq will prohibit independent compensation committee members from accepting, directly or indirectly, any consulting, advisory or other compensatory fee from the listed company;
- 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
- Both the NYSE and Nasdaq declined to supplement the six factors for evaluating advisor independence that the SEC identified in the Final Rules.

¹ The NYSE amended its proposal on October 2, 2012 to correct an error in the text of its proposed rules relating to transition periods for compensation committee requirements.

² See 17 C.F.R. 240.10C-1.

³ 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/>.

Compensation Committee Requirements

Nasdaq. Nasdaq's proposal would 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 stockholders, Nasdaq believes that it is appropriate to require that more than one director be responsible for these decisions. Nasdaq proposed consideration of the additional independence factors as required under the Final Rules and described below.

NYSE. The NYSE already requires a standing compensation committee consisting of independent directors but does not dictate a minimum number of required members.⁴ The NYSE also proposed consideration of the additional independence factors as required under the Final Rules.

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.

Nasdaq. Currently, the Nasdaq rules set forth a two-part test to determine director independence. 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. The proposed rules retain the current provisions but modify one of the categories of directors that will not be considered independent: the proposal conforms to the current requirements for audit committee independence and characterizes as not independent, directors who receive *any* (rather than, as under current Nasdaq rules, more than a threshold amount of) consulting, advisory or other compensatory fee from the listed company (other than fees

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.

for service as a member of the board or any board committee and fixed amounts of compensation under a retirement plan for prior service with the company). 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.⁶

NYSE. Current NYSE rules also provide for a two-part independence determination test. First, if a director has a relationship with a listed company that violates one of five listed “bright line” tests,⁷ 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). The NYSE proposes an additional test that would require the board to 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,” in addition to the two SEC factors described above.

Interestingly, neither the NYSE nor Nasdaq proposed 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 authority to retain compensation consultants, independent legal advisors and other compensation advisors, (ii) adequate funding to pay the advisors, and (iii) responsibility to consider independence factors when hiring their advisors, other than in-house counsel. The Final Rules and the proposed listing rules for each exchange make clear that the compensation

⁶ The Nasdaq proposal 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 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 issuer’s website or the next proxy statement.

⁷ 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 serves or served on that company’s compensation committee, (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.

committee is directly responsible for the appointment, compensation and oversight of the work of any advisor it retains and it may only select an advisor after taking into consideration all factors relevant to that person's independence from management. The compensation committee is not required to take the advice of any of its advisors and the proposed rules may not be construed to affect the compensation committee's ability to exercise its own judgment.

The Final Rules set forth a list of six factors a compensation committee must consider prior to hiring an advisor.⁸ Although the SEC invited the exchanges to add to the list, neither Nasdaq nor the NYSE elected to do so.

Compensation Committee Charters

Nasdaq. Nasdaq does not currently require listed companies to adopt a written compensation committee charter. The proposed rules would 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;
- 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; and
- That the chief executive officer may not be present during voting or deliberations on his or her compensation.

The charter must also set forth the committee's authority regarding its advisors as described in the preceding section. Listed companies must certify that they have adopted a charter by the earlier of the second annual meeting following approval of the proposed rules or December 31, 2014, and that they will review and assess the adequacy of the charter on an annual basis.⁹

NYSE. The NYSE currently requires compensation committees to have a written charter. The proposed rule adds 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 issuer to the exchange, could remain on the committee until the

⁸ 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 issuer.

⁹ Currently Nasdaq 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 proposed rules would also amend this requirement for the audit committee to make it prospective, rather than retrospective, to conform to the proposal for compensation committees.

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 proposal would allow companies additional time in the event the noncompliance 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.

NYSE. The NYSE's proposal 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.

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 proposes to expand the Final Rules and 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 proposes 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 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 proposed rules would need to disclose the differences in its corporate governance practices from the domestic issuer requirements. Disclosure of the reasons for these differences is not required under the proposed rules, 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 and smaller reporting 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 issuers.

Nasdaq. Nasdaq's compensation committee requirements would also not apply to asset-backed issuers and other passive issuers, cooperatives, or issuers, 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. Nasdaq currently exempts these entities from its compensation-related listing rules because of their unique structures.

NYSE. The NYSE's compensation committee requirements would also not apply to closed-end and open-end funds registered under the 1940 Act, passive business organizations in the form of trusts, derivatives and special purpose securities and issuers whose only listed equity security is preferred stock. The NYSE indicates that these categories of issuers tend not

to directly employ executives, have employees or set their own executive compensation structures, and requiring them to establish compensation committees would be unduly burdensome.

Smaller Reporting Companies

Nasdaq. Under Nasdaq's proposed rules, a smaller reporting company would generally be exempt from the compensation committee 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.

NYSE. Under the NYSE's proposed rules, smaller reporting companies would not be required to comply with the enhanced definition of "independent director". However, all other proposed rules would apply other than the advisor independence test.

Effective Dates

The proposed rules must be approved by the SEC and in place by June 27, 2013. Following adoption of the final rules:

- Nasdaq rules relating to the committee's (i) authority to retain advisors, (ii) funding to retain advisors, and (iii) requirement to analyze advisor independence will be effective immediately upon approval of the proposed rules by the SEC. Compliance with the remaining provisions will be required by the earlier of: (1) the listed company's second annual meeting after the date the Nasdaq rules are approved, or (2) December 31, 2014. Companies must certify compliance with the applicable requirements no later than 30 days after the applicable implementation deadline.
- 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.

Conclusion

Listed companies that will become subject to the proposed NYSE or Nasdaq rules should begin thinking about whether their current compensation committee membership and committee structure will satisfy the proposed rules. Companies may also want to start thinking of ways to implement the compensation committee advisor rules. No action is required, however, until the rules become effective next year.

This memorandum is intended only as a general discussion of these issues. It should not be regarded as legal advice. We would be pleased to provide additional details or advice about specific situations if desired.

If you wish to receive more information on the topics covered in this publication, you may contact your regular Shearman & Sterling contact person or any of the following:

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