

Client Alert

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NYSE and NASDAQ Adopt Listing Standard Amendments Related to Compensation Committees and Compensation Advisers

The Securities and Exchange Commission (the “SEC”) recently approved changes to the New York Stock Exchange¹ (the “NYSE”) and the NASDAQ Stock Market² (the “NASDAQ”) listing standards relating to compensation committees and compensation advisers. These changes implement SEC rules adopted under Section 10C³ of the Securities Exchange Act of 1934, as amended (the “Exchange Act”), as mandated by Section 952 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the “Dodd-Frank Act”), and comply with Exchange Act Rule 10C-1, which directed the national securities exchanges to adopt listing standards that address the following:

- the independence of compensation committee members;
- the compensation committee’s funding and authority to retain compensation advisers;
- the compensation committee’s consideration of the independence of any compensation advisers it retains; and
- the compensation committee’s responsibility for the appointment, compensation and oversight of the work of any compensation advisers it retains.

While the NYSE and the NASDAQ generally did not stray far from the SEC rules codifying the statutory requirements under the Dodd-Frank Act, the NASDAQ adopted various additional requirements.

Compensation Committee Independence

NYSE. The NYSE adopted Section 303A.02(a)(ii), which requires that in affirmatively determining the independence of any director who will serve on the compensation committee of the listed company’s board of directors, the board of directors must consider all factors specifically relevant to determining whether a director has a relationship to the listed 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 new standards require that in making this independence determination the listed company board consider the following two factors, in addition to the existing general and bright-line independence tests:

- the director’s source of compensation, including any consulting, advisory or other compensatory fees paid by the listed company; and
- whether the director is affiliated with the listed company, a subsidiary of the listed company or an affiliate of a subsidiary of the listed company.

¹ The SEC’s order approving the NYSE’s final listing standards is available [here](#).

² The SEC’s order approving the NASDAQ’s final listing standards is available [here](#).

³ For additional information on the SEC’s final rules, please see our prior alert [here](#).

The commentary to the new standard provides that, when considering the sources of a director's compensation in determining his or her independence for purposes of compensation committee service, the board should consider whether the director receives compensation from any person or entity that would impair his or her ability to make independent judgments about the listed company's executive compensation.

Similarly, commentary to the new listing standards provides that, when considering any affiliate relationship a director has with the company, a subsidiary or an affiliate of a subsidiary in determining his or her independence for purposes of compensation committee service, the board should consider whether the affiliate relationship:

- places the director under the direct or indirect control of the listed company or its senior management, or
- creates a direct relationship between the director and members of senior management,

in each case, of a nature that would impair his or her ability to make independent judgments about the listed company's executive compensation.

In adopting these new listing standards, the NYSE did not prescribe any specific numerical tests with respect to the factors discussed above nor adopt a requirement to consider any other specific factors. The requirements enhance its previous independence standards, making the listing standards consistent with the requirements of Exchange Act Rule 10C-1, while still leaving the board of directors discretion to consider other non-enumerated relevant factors in its independence determination.

NASDAQ. NASDAQ adopted Listing Rule 5605(d)(3), which requires all listed companies to establish a compensation committee consisting of at least two members who qualify as independent directors under NASDAQ's existing general and bright-line independence tests. Similar to the NYSE standards, the NASDAQ standards also require that, in determining whether a director is eligible to serve on a compensation committee, a listed company's board must consider whether the director is affiliated with the company, a subsidiary or an affiliate of a subsidiary to determine whether such affiliation would impair the director's judgment as a member of the compensation committee. Like the NYSE standards, these standards do not provide for any bright-line prohibition with respect to affiliation, but provide rather a structure to guide the analysis in the independence determination.

However, in arguably the most striking difference from the NYSE approach to the new listing standards, NASDAQ's new listing standards prohibit a compensation committee member from accepting directly or indirectly any consulting, advisory or other compensatory fee from an issuer or any subsidiary, other than:

- fees received as a member of the compensation committee, the board of directors or any other board committee; or
- 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).

This "bright-line" approach taken by NASDAQ regarding consulting, advisory or other compensatory fees mirrors that of the independence standard applicable to audit committee members under Exchange Act Rule 10A-3 and the NASDAQ's and NYSE's existing heightened independence standards. This prohibition does not include a "look-back" period, and, therefore, 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.

Furthermore, NASDAQ's listing standards provide that listed companies may continue to rely on the existing exception that allows certain non-independent directors to serve on a compensation committee under exceptional and limited circumstances.

Cure Periods

NYSE. The NYSE listing standards provide a cure period within which time a listed company not in compliance with the standards may become compliant. If a member of a compensation committee ceases to be independent in accordance with the requirements of the listing standards for reasons outside the member's reasonable control, and as long as the committee continues to have a majority of independent directors, the non-compliant director may remain on the compensation committee until the earlier of the next annual meeting or one year from the occurrence of the event that caused the member to be no longer independent.

NASDAQ. The NASDAQ listing standards also provide for a cure period. If a listed company fails to comply with the requirements due to one vacancy or one compensation committee member ceases to be independent due to circumstances beyond the member's reasonable control, the listed company must regain compliance by the earlier of the next annual meeting or one year from the occurrence of the event that caused the non-compliance. However, if the annual meeting occurs no later than 180 days following the event that caused the non-compliance, the company instead has 180 days from such event to regain compliance with the requirements. The listing standards also require the listed company to provide prompt notice to NASDAQ of the non-compliance.

Compensation Committee Responsibilities

Authority to Access Advisers. Both the NYSE and the NASDAQ adopted the requirements of Exchange Act Rules 10C-1(b)(2) and (3) regarding a compensation committee's broad authority to engage advisers to assist in its committee functions and the funding of those advisers. Under these standards:

- the compensation committee may, in its sole discretion, retain or obtain the advice of a compensation consultant, independent legal counsel or other adviser;
- the compensation committee must be directly responsible for the appointment, compensation and oversight of the work of any compensation consultant, independent legal counsel and other adviser retained by the compensation committee; and
- the listed company must provide for appropriate funding, as determined by the compensation committee, for payment of reasonable compensation to a compensation consultant, independent legal counsel or any other adviser retained by the compensation committee.

Adviser Independence Factors. Pursuant to Exchange Act Rule 10C-1(b)(4), the NYSE and the NASDAQ adopted new listing standards specifying that, before engaging a compensation consultant, legal counsel or other adviser, the compensation committee must consider the following six factors:

- the provision of other services to the listed company by the person that employs the compensation consultant, legal counsel or other adviser;
- the amount of fees received from the listed company by the person that employs the compensation consultant, legal counsel or other adviser, as a percentage of the total revenue of the person that employs the compensation consultant, legal counsel or other adviser;
- the policies and procedures of the person that employs the compensation consultant, legal counsel or other adviser that are designed to prevent conflicts of interest;
- any business or personal relationship of the compensation consultant, legal counsel or other adviser with a member of the compensation committee;
- any stock of the listed company owned by the compensation consultant, legal counsel or other adviser; and
- any business or personal relationship of the compensation consultant, legal counsel, other adviser or the person employing the adviser with an executive officer of the listed company.

Neither the NYSE nor the NASDAQ adopted any additional specific factors other than the six listed above. However, the new NYSE listing standards also require the compensation committee to consider any other factors

that would be relevant to the adviser's independence from management.

Under both the NYSE and the NASDAQ listing standards, the consideration of the factors listed above is required only in the selection of independent advisers. As a result, an analysis of the independence factors is not required before consulting with or obtaining advice from in-house legal counsel. In addition, under both the NYSE and the NASDAQ listing standards, a compensation committee is not required to conduct the independence assessment required with respect to a compensation adviser that acts in a role 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 of the listed company, and that is available generally to all salaried employees; or (ii) providing information that either is not customized for a particular listed company or that is customized based on parameters that are not developed by the adviser, and about which the adviser does not provide advice. Both sets of listing standards also clarify that nothing in the new rules requires compensation consultants, legal counsel or other compensation advisers to be independent, only that the independence factors be considered before selecting or receiving advice from a compensation adviser. Finally, the listing standards of the NYSE and the NASDAQ provide that the compensation committee is not required to implement or act consistently with the advice or recommendation of their advisers and that nothing affects the ability or obligation of the compensation committee to exercise its own judgment in fulfillment of its duties.

It should also be noted that in addition to the newly-adopted NYSE and NASDAQ listing standards, Item 407(e)(3)(iv) of Regulation S-K⁴ requires disclosure of conflicts of interest with any compensation consultant engaged by the company or the compensation committee and the compensation consultant. This disclosure requires the issuer to provide a description of the nature of the conflict and how it is being addressed. For purposes of whether a conflict of interest exists, the instructions to Item 407(e)(3)(iv) provide that issuers are to consider the six factors set forth in Exchange Act Rule 10C-1(b)(4), which are listed above.

Additional NASDAQ Requirements. While the NYSE's listing standards already required listed companies to have an independent compensation committee with a committee charter, NASDAQ adopted Listing Rule 5605(d)(3), which modified its previous listing standards that did not mandate similar requirements. NASDAQ's new listing standards now require all listed companies to have a compensation committee consisting of at least two independent directors and require each listed company to certify that it has adopted a formal written compensation committee charter. Furthermore, under the NASDAQ listing standards, the listed company must certify that the compensation committee will review and reassess the adequacy of the formal written charter on an annual basis. The listing standards also require that the charter 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 Listing Rule 5605(d)(3), which implements the requirements of Section 10C(b)-(e) of the Exchange Act and Exchange Act Rule 10C-1(b)(2), (3) and (4)(i)-(vi) thereunder.

Applicability and Exemptions

NYSE. The NYSE exempted from its listing standards requirements for compensation committee members each of the following categories of issuers:

- controlled companies;

⁴ For additional information on Item 407(e)(3) of Regulation S-K, please see our prior alert [here](#).

- limited partnerships;
- companies in bankruptcy proceedings;
- closed-end and open-end funds registered under the Investment Company Act of 1940;
- passive business organizations in the form of trusts (such as royalty trusts);
- derivatives and special purpose securities; and
- issuers whose only listed equity security is preferred stock.

The existing NYSE listing standards provide that foreign private issuers are permitted to follow home country practice in lieu of compliance with the compensation committee listing standards, but require foreign private issuers to disclose any significant ways in which their corporate governance practices differ from those followed by domestic companies. Foreign private issuers that are required to file an annual report on Form 20-F with the SEC must also include their statement of significant differences in that annual report. However, all other foreign private issuers may either (i) include the statement of significant differences in an annual report filed with the SEC or (ii) make the statement of significant differences available on or through the listed company's website.

The NYSE listing standards require only that smaller reporting companies comply with the new listing standards relating to the authority of compensation committees to retain compensation advisers and that smaller reporting companies fund such compensation advisers.

NASDAQ. The NASDAQ's listing standards exemptions remain generally unchanged, exempting the following categories of issuers:

- asset-backed issuers and other passive issuers;
- cooperatives;
- limited partnerships;
- management investment companies; and
- controlled companies.

With regard to foreign private issuers, the existing NASDAQ listing standards provide that the listed company may follow its home country practice in lieu of NASDAQ's compensation committee standards if the foreign private issuer discloses in its annual reports filed with the SEC each requirement that it does not follow and describes the home country practice followed by the company in lieu of such requirements. A foreign private issuer that is not required to file its annual report with the SEC on Form 20-F may make this disclosure only on its website. For any foreign private issuer that follows its home country practice in lieu of the requirement to have an independent compensation committee, the new listing standards added a requirement to disclose in its annual reports filed with the SEC the reasons why it does not have such a committee.

The listing standards require smaller reporting companies to have a compensation committee that comprises at least two directors who are independent under the existing general and bright-line independence tests only and to certify as such. The new listing standards also provide that smaller reporting companies must certify that they have adopted formal written compensation committee charters or board resolutions that specify the committee's responsibilities and authority; however, they are not required to specify the specific compensation responsibilities and authority relating to (i) the authority to retain compensation advisers; (ii) the authority to fund such advisers; and (iii) the responsibility to consider certain independence factors before selecting such advisers. Smaller reporting companies are exempt from the other new NASDAQ listing standards.

Effective Dates

NYSE. The adopted NYSE listing standards become effective on July 1, 2013. However, compliance with the compensation committee member independence standards for NYSE-listed companies is required by the earlier of: (1) their first annual meeting after January 15, 2014; and (2) October 31, 2014.

NASDAQ. The adopted listing standards relating to the compensation committee responsibilities and authority to comply with Exchange Act Rule 10C-1 relating to (i) the authority to retain compensation consultants, legal counsel and other compensation advisers; (ii) the authority to fund such advisers; and (iii) the responsibility to consider certain independence factors before selecting such advisers become effective on July 1, 2013. However, NASDAQ-listed companies must comply with the remaining listing standards by the earlier of: (1) their first annual meeting after January 15, 2014; and (2) October 31, 2014.

Regulation S-K Item 407(e)(3)(iv). Issuers subject to the federal proxy rules are required to disclose compensation consultant conflicts of interest pursuant to Item 407(e)(3)(iv) in any proxy statements or information statements for annual meetings (or special meetings in lieu of annual meetings) held on or after January 1, 2013, at which directors are elected.

Next Steps

With the adoption of the new listing standards, listed companies should:

- review the independence of the members of their compensation committees under the new independence standards;
- review and, if needed, update their compensation committee charters to comply with the new standards, or if the company is listed on the NASDAQ and does not have a compensation committee or a committee charter, the company should begin ensuring that these are created in compliance with the new listing standards;
- apply the independence standards and consider any potential conflicts of interest as they engage in a compensation consultant, legal counsel or other adviser;
- consider amending their director and officer questionnaires to include questions that will assist in determining independence under the new independence standards; and
- design a process to obtain information from a compensation consultant or entity that employs the compensation consultant that is relevant for assessing their independence and any potential conflicts of interest (e.g., a separate questionnaire for the compensation consultant or entity that employs the compensation consultant).

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