

Client Alert.

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SEC Approves New Compensation Committee and Adviser Independence Listing Standards

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As discussed in two previous Client Alerts,¹ on June 20, 2012, the U.S. Securities and Exchange Commission (the “SEC”) adopted Rule 10C-1 to implement the provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the “Dodd-Frank Act”) that affect the composition of compensation committees, the use of compensation advisers by companies listed on national securities exchanges, and disclosure provided by companies regarding their use of compensation consultants.²

Under Rule 10C-1, the national securities exchanges were directed to provide the SEC with proposed changes to their listing standards related to compensation committee and adviser independence. The New York Stock Exchange (“NYSE”) and Nasdaq submitted their proposed changes to the SEC on September 25, 2012.³ Both exchanges later submitted amendments to their proposals⁴ and the SEC approved the exchanges’ proposals, as amended, on January 11, 2013.⁵

BACKGROUND

Section 952 of the Dodd-Frank Act added Section 10C to the Securities Exchange Act of 1934 (the “Exchange Act”). Section 10C requires the SEC to direct the national securities exchanges and associations to prohibit the listing of any company issuing equity securities, subject to limited exceptions, unless specific conditions are satisfied with respect to the authority of the compensation committee, the independence of the members of the compensation committee, and the consideration by the compensation committee of specific factors relating to the independence of compensation advisers (including consultants, legal counsel, and other advisers).

¹ [SEC Adopts Dodd-Frank Compensation Committee and Adviser Independence Rules \(June 21, 2012\)](#); [Stock Exchanges Submit Proposed Compensation Committee and Adviser Independence Rule Changes to SEC \(Oct. 3, 2012\)](#).

² [Listing Standards for Compensation Committees, Securities Act Release No. 33-9330, Exchange Act Release No. 34-67220 \(June 20, 2012\)](#).

³ [New York Stock Exchange, Form 19b-4 Proposed Rule Change by New York Stock Exchange \(Sept. 25, 2012\)](#), amended by [New York Stock Exchange, Amendment No. 1 to Form 19b-4 Proposed Rule Change by New York Stock Exchange \(Oct. 1, 2012\)](#); [The NASDAQ Stock Market LLC, Form 19b-4 Proposed Rule Change by NASDAQ Stock Market \(Sept. 25, 2012\)](#).

⁴ [New York Stock Exchange, Amendment No. 1 to Form 19b-4 Proposed Rule Change by New York Stock Exchange \(Oct. 1, 2012\)](#); [New York Stock Exchange, Amendment No. 3 to Form 19b-4 Proposed Rule Change by New York Stock Exchange \(Jan. 8, 2013\)](#); [NASDAQ Stock Market LLC, Amendment No. 1 to Form 19b-4 Proposed Rule Change by NASDAQ Stock Market \(Dec. 12, 2012\)](#); [NASDAQ Stock Market LLC, Amendment No. 2 to Form 19b-4 Proposed Rule Change by NASDAQ Stock Market \(Jan. 4, 2013\)](#). The NYSE had also filed a proposed [Amendment No. 2](#), but withdrew that amendment the day before filing Amendment No. 3.

⁵ [Exchange Act Release No. 34-68639 \(Jan. 11, 2013\)](#) (order approving the NYSE’s proposed rule changes, as amended); [Exchange Act Release No. 34-68640 \(Jan. 11, 2013\)](#) (order approving Nasdaq’s proposed rule changes, as amended).

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COMPENSATION COMMITTEE MEMBER INDEPENDENCE

Under the SEC's Rule 10C-1, the exchanges were directed to adopt listing standards related to the independence of compensation committee members. Although neither the Dodd-Frank Act nor Rule 10C-1 specifically defines independence for this purpose, the listing standards adopted by national securities exchanges must consider:

- the sources of compensation of the director, including any consulting, advisory, or other compensatory fee paid by the company to the director; and
- whether the director is affiliated with the company or any of its subsidiaries or their affiliates.

Rule 10C-1 provided the exchanges with more discretion in setting the definition of independence than is permitted in determining the independence of audit committee members.⁶ In its rulemaking, the SEC did not adopt any additional factors to be considered by the exchanges in establishing their listing standards beyond what was required under the Dodd-Frank Act, which left open the possibility that the exchanges would consider and adopt additional relevant factors to be considered when determining whether a compensation committee member is independent.

The new NYSE and Nasdaq listing standards do not, however, include any additional criteria to be considered in determining whether a member of the compensation committee is independent. The commentary to both the NYSE's and Nasdaq's proposals makes clear that in order to be considered independent, members of the compensation committee must meet both the general independence criteria already included in the exchanges' listing standards and the new, compensation committee-specific criteria required by Rule 10C-1.

The new NYSE listing standards provide some guidance as to how issuers should apply the two factors listed above in making an independence determination. With respect to sources of compensation, the commentary to the new NYSE standards instructs the listed company's board to consider whether the director receives compensation from any person or entity that would impair the director's ability to make independent judgments about the listed company's executive compensation. Similarly, when considering any affiliate relationship, the commentary to the new listing standards instructs the board to consider whether there is an affiliate relationship that 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 ability to make independent judgments about the listed company's executive compensation." The NYSE specifically declined to include a bar on independence based solely on affiliate status due to stock ownership.

Unlike the NYSE approach, Nasdaq's new listing standards attempt to harmonize the committee-specific independence standards applicable to members of audit and compensation committees by applying the independence standards currently required of audit committee members to directors serving on compensation committees. Accordingly, Nasdaq's standards prohibit a compensation committee member from accepting directly or indirectly any consulting, advisory, or other compensatory fee from an issuer or any subsidiary. As is the case with Nasdaq's audit committee independence requirements and the NYSE independence analysis discussed above, an individual's status as an affiliate due solely to stock ownership is not an automatic bar to an

⁶ Rule 10A-3 provides that in order to be considered independent, a member of the audit committee may not, other than in his or her capacity as a member of the audit committee, the board of directors, or any other committee: (i) accept any consulting, advisory, or other compensatory fee from the company; or (ii) be an affiliated person of the company or any subsidiary thereof. See Rule 10A-3(b)(ii).

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independence determination.⁷ Instead, in making this eligibility determination, the board must consider whether a director's status as an affiliate due to stock ownership "would impair the director's judgment as a member of the compensation committee." There is no "look-back" period for these requirements, which only begin with the member's term of service on the compensation committee.

Nasdaq's new listing standards go a step further than required under the Dodd-Frank Act or Rule 10C-1 in requiring all listed companies to have a standing compensation committee with at least two members. Prior to this change, Nasdaq only required that compensation of the chief executive officer and other executive officers of a company must be determined, or recommended to the board for determination, by either: (i) a compensation committee comprised solely of independent directors; or (ii) independent directors constituting a majority of the board's independent directors in a vote in which only independent directors participate.

COMPENSATION COMMITTEE AUTHORITY AND FUNDING

Rule 10C-1 also directed the exchanges to prohibit the listing of a security of an issuer that is not in compliance with the following standards:

- The compensation committee, which for this purpose includes those members of a the board of directors who oversee executive compensation matters on behalf of the board of directors in the absence of a board committee, must be directly responsible for the appointment, compensation, and oversight of the work of any compensation advisers;
- The compensation committee, in its sole discretion, must have authority to retain or obtain the advice of compensation advisers;
- The issuer must provide the appropriate funding for the payment of reasonable compensation, as determined by the compensation committee, to the compensation advisers, if any; and
- Before selecting any compensation adviser, the compensation committee must take into consideration the six independence criteria specified in Rule 10C-1 (described below), as well as any additional factors specified in the listing criteria adopted by the exchanges.

The SEC made clear that Rule 10C-1 does not require that the compensation committee act in accordance with the advice of compensation advisers or otherwise affect the ability or obligation of the compensation committee to exercise its own judgment. Further, Rule 10C-1 and the resulting listing standards are not intended to preclude obtaining advice from in-house counsel. Rule 10C-1 and both exchanges' new listing standards also make clear that while the compensation committee must conduct an independence assessment in selecting a compensation adviser, companies may still retain and seek advice from advisers who are not independent (subject to the new compensation adviser disclosure requirements in Item 407 of Regulation S-K).

The new NYSE and Nasdaq listing standards both require companies to impose the requirements listed above on their compensation committees. The NYSE noted in its commentary that the required powers of the compensation committee set forth above had in significant part already been required by existing NYSE listing standards, which require these powers to be included in the compensation committee charter. In any case, the NYSE adopted the requirements noted above exactly as they appear in Rule 10C-1, and removed the comparable requirements

⁷ Nasdaq noted in the commentary to its proposal that, unlike audit committees, "it may be appropriate for certain affiliates, such as representatives of significant stockholders, to serve on compensation committees since their interests are likely aligned with those of other stockholders in seeking an appropriate executive compensation program."

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included in existing NYSE listing standards. Nasdaq's new listing standards also require that, subject to certain exceptions described below, listed companies adopt a formal compensation committee charter that states that the compensation committee will review and reassess the adequacy of the charter on an annual basis.⁸ The new NYSE and Nasdaq listing standards require that the above-referenced authority and funding considerations be addressed in the compensation committee charter.

COMPENSATION ADVISER INDEPENDENCE

Rule 10C-1 also directed the exchanges to adopt listing standards requiring that the compensation committee consider the independence factors specified in Rule 10C-1, as well as any other relevant factors identified by the exchange, prior to engaging any compensation advisers.⁹ The independence criteria specified in Rule 10C-1 are:

- The provision of other services to the company by the firm employing the compensation adviser;
- The amount of fees received from the company by the firm employing the compensation adviser, as a percentage of that firm's total revenue;
- The policies and procedures adopted by the firm employing the compensation adviser that are designed to prevent conflicts of interest;
- Any business or personal relationship of the compensation adviser with a member of the compensation committee;
- The compensation adviser's ownership of the company's stock; and
- Any business or personal relationships between the company's executive officers and the compensation adviser or the firm employing the adviser.

As with the criteria relating to compensation committee member independence, the new NYSE and Nasdaq listing standards do not include any additional factors to be considered in determining the independence of compensation advisers beyond those in Rule 10C-1.

Consistent with the new compensation adviser disclosure requirements in Item 407 of Regulation S-K, adopted by the SEC in July 2012, the new NYSE and Nasdaq listing standards provide that a compensation committee is not required to conduct the independence assessment with respect to a compensation adviser that acts in a role limited to (1) consulting on any broad-based plan that does not discriminate in scope, terms, or operation, in favor of executive officers or directors of the registrant, and that is available generally to all salaried employees or (2) providing information that either is not customized for a particular registrant or that is customized based on parameters that are not developed by the compensation consultant, and about which the compensation consultant does not provide advice.¹⁰

⁸ This requirement is a shift from Nasdaq's annual review requirement applicable to audit committee charters, which requires the charter to state that the audit committee *has* reviewed and reassessed the adequacy of the charter on an annual basis. See Nasdaq Listing Rule 5605(c)(1). Nasdaq's new listing standards modify the audit committee requirement to make it prospective as well.

⁹ Rule 10C-1 and the commentary to the exchanges' new listing standards make clear that, although the six factors must be considered prior to engaging a compensation adviser, a compensation committee need not consider the six independence factors before consulting with or obtaining advice from in-house counsel.

¹⁰ See Item 407(e)(3)(iii) of Regulation S-K.

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EXEMPTIONS AND APPLICABILITY OF LISTING STANDARDS

The new listing standards for compensation committee member independence and compensation committee adviser independence do not apply to controlled companies, issuers of securities futures products cleared by a registered clearing agency or a clearing agency exempt from registration, or registered clearing agencies that issue standardized options. The following categories of companies are also exempt from the compensation committee member independence requirements:

- limited partnerships;
- companies in bankruptcy proceedings;
- open-end management investment companies registered under the Investment Company Act of 1940;
- foreign private issuers that disclose annually why they do not have an independent compensation committee; and
- smaller reporting companies.

The new NYSE and Nasdaq listing standards both include general exemptions for other categories of issuers that are currently exempt from their existing compensation committee requirements. These include passive business organizations and issuers whose only listed equity security is a preferred stock.

The listing standards of both the NYSE and Nasdaq already provide that a foreign private issuer may follow its home country's practice rather than U.S. compensation-related listing standards so long as the issuer discloses in its annual reports filed with the SEC each requirement that it does not follow and describes the home country practice the issuer follows in lieu of such requirements. Under both the NYSE and Nasdaq listing standards, a foreign private issuer that follows its home country's practice in lieu of the requirement to maintain an independent compensation committee must now also disclose in its annual reports filed with the SEC the reasons why it does not have such a committee.

Under both the NYSE and Nasdaq listing standards, smaller reporting companies are not required to adhere to the new enhanced independence standards for compensation committee members or the new compensation adviser independence considerations. Nasdaq's new listing standards also permit smaller reporting companies to adopt a board resolution that specifies the compensation committee's responsibilities and authority in lieu of adopting a formal written compensation committee charter. Further, under Nasdaq's new listing standards, smaller reporting companies are not required to include language regarding the committee's authority to retrain compensation advisers in the compensation committee charter or board resolutions. Under Nasdaq's listing standards, smaller reporting companies are also exempt from the requirement to review the compensation committee charter or board resolutions on an annual basis.

IMPLEMENTATION TIMELINE

Under the new NYSE listing standards, companies have until the earlier of (1) their first annual meeting after January 15, 2014, or (2) October 31, 2014, to comply with the new compensation committee independence requirements. Companies are required to comply with the other new standards, including those related to the funding and authority of the compensation committee and the independence of compensation committee advisers, by July 1, 2013.

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Under the new Nasdaq listing standards, companies have until the earlier of (1) their second annual meeting held after January 11, 2013, or (2) December 31, 2014, to comply with the new compensation committee independence requirements. Nasdaq-listed companies must comply with the other new standards, including those related to the funding and authority of the compensation committee and the independence of compensation committee advisers, by July 1, 2013.

Both the NYSE and Nasdaq listing standards provide listed companies with opportunities to cure compensation committee member independence issues after the new standards go into effect. Under the new NYSE listing standards, if a member of a compensation committee ceases to be independent for reasons outside the member's reasonable control, that member 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. Notably, however, the cure period provided under the NYSE standards is limited to circumstances where the compensation committee continues to have a majority of directors who are independent under the new listing standards. Under the new Nasdaq listing standards, the listed company is required to cure any noncompliance by the earlier of the next annual shareholders meeting or one year from the occurrence of the event that caused the noncompliance.¹¹ Both exchanges' listing standards require companies to notify the relevant exchange upon learning of noncompliance.

The new NYSE and Nasdaq listing standards both generally provide a phased-in compliance period for newly listed companies. These issuers are required to have one independent compensation committee member at the time of listing, a majority of independent compensation committee members within 90 days of listing, and all independent compensation committee members within one year of listing.

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¹¹ Nasdaq's new listing standards provide that if the annual shareholders meeting occurs within less than 180 days following the event that caused the noncompliance, the company "shall instead have 180 days from such event to regain compliance." As Nasdaq noted in the commentary to its proposal, this provides the company at least 180 days to cure noncompliance and would allow most companies to regain compliance in connection with their next annual meeting.