OnPoint Dechert LLP

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A legal update from Dechert's Corporate and Securities Group

SEC Approves Exchanges’ Proposed Rules for Compensation Committees and Their Advisers

The U.S. Securities and Exchange Commission (“SEC”) formally approved several new listing rules proposed by NASDAQ and the NYSE on January 11, 2013.[1] The new listing rules are designed to bring the listing standards of each exchange into compliance with both the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank Act”) and Rule 10C-1 of the Securities Exchange Act of 1934 (“Rule 10C-1”) which governs compensation committees of listed companies. Once fully implemented, the new listing rules will:

- Establish additional independence requirements for compensation committee members (or any director or directors performing the function of a compensation committee).
- Require listed companies to grant compensation committees the authority to retain and pay compensation advisers.
- Require the compensation committees of listed companies to assess the independence of any adviser that advises the compensation committee and any director that serves on the compensation committee.[2]

Effectiveness of New Listing Standards

For both exchanges, the compensation committee adviser requirements and the compensation committee charter requirements described below become effective on July 1, 2013, while the new compensation committee member independence standards become effective on the earlier of a listed company’s first annual meeting after January 15, 2014 or October 31, 2014.[3] Generally, the new listing rules are not retrospective and therefore do not require the board to review committee membership or committee action that occurred prior to the effectiveness of the new listing rules.

Eligibility and Exemptions

The new listing rules generally apply only to companies with equity securities listed on NASDAQ or the NYSE. While the specific exemption requirements vary between the two exchanges, there are several general categories of issuers that are exempt from all or a portion of the new listing rules:

- Companies that were previously exempt from the compensation-related listing rules are also exempt from compliance with the new listing rules. For companies listed on the NYSE, this includes controlled companies, limited partnerships, companies in bankruptcy and open and closed-end funds registered under the Investment Company Act of 1940.
- Foreign private issuers that follow the practice of their home jurisdiction are exempt from the compensation committee independence and compensation committee adviser requirements described herein. Foreign private issuers listed on the NYSE that follow the practice of their home country must disclose any significant ways in which their corporate governance practices differ from the NYSE’s listing standards. Foreign private issuers listed on NASDAQ that do not have compensation committees because they follow the practice of their home country must disclose that fact to the SEC.

- Newly listed companies, companies emerging from bankruptcy and companies that cease to be "controlled companies" are subject to the new listing rules, however, they may take advantage of any transition period available to such companies under the rules of the exchange on which they are listed.
- Smaller reporting companies are now required to have a compensation committee that is comprised of at least two independent directors and a compensation committee charter or board resolution describing the authority and responsibilities of the committee. However, smaller companies are not required to comply with certain rules regarding compensation committee eligibility requirements or requirements relating to compensation advisers.

New Listing Rules

While the new listing rules are primarily designed to implement the Dodd-Frank Act and Rule 10C-1, NASDAQ has also included several requirements conforming its listing standards to the NYSE's listing standards.

- Listed companies are required to have a standing compensation committee consisting of at least two members, each of whom must be an "independent" director. In determining whether a director is independent boards must consider two additional factors: (i) the source of compensation received by a director from the company or its subsidiaries as consulting, advisory or other fees and (ii) whether a director has an affiliate relationship with the listed company or any of the listed company's subsidiaries or affiliates.[4] The compensation committee requirement is an existing requirement for companies listed on the NYSE, but it is a new requirement for companies listed on NASDAQ. A NASDAQ-listed company that does not currently have a compensation committee is not required to have such a committee until the earlier of its first annual meeting after January 15, 2014 or October 31, 2014.
- For companies listed on NASDAQ, members of the compensation committee are not permitted to accept (whether directly or indirectly) any consulting or advisory fee (other than fees for service on the board, or any committee thereof, or amounts under a vested retirement plan for prior service with the company). A director's receipt of such a fee disqualifies that director from serving on the compensation committee. For companies listed on the NYSE, the receipt of such a fee is merely a factor that must be considered by the board in its determination of whether the director is independent from management. The rules barring compensatory fees do not include a "look-back" period and therefore only apply during a director's tenure on the compensation committee.
- Compensation committees must have a written charter that is reviewed and assessed by the compensation committee on an annual basis. Among other things, the charter must describe the scope of the compensation committee's responsibilities, its authority to engage advisers to the committee (including the factors it must consider when engaging such advisers) and its ability to receive funding from the company to pay its advisers. Companies listed on the NYSE are already required to have a compensation committee charter, but this is a new requirement for companies listed on NASDAQ. Both the NYSE and NASDAQ follow the SEC's final rules that provide that the compensation committee is not required to follow its advisers' advice and that nothing prohibits the committee from exercising its own judgment in fulfilling its duties.
- When deciding whether to engage a compensation adviser (including outside counsel), the compensation committee must consider the six "Independence Factors" promulgated by the SEC. The Independence Factors are:

1. The provision of other services to the issuer by the person that employs the adviser;
2. The amount of fees received from the issuer by the person that employs the adviser, as a percentage of the total revenue of the person that employs the adviser;
3. The policies and procedures of the person that employs the adviser that are designed to prevent conflicts of interest;
4. Any business or personal relationship of the adviser with a member of the compensation committee;
5. Any stock of the issuer owned by the adviser; and
6. Any business or personal relationship of the adviser or the person employing the adviser with an executive officer of the issuer.

In addition to the Independence Factors, companies listed on the NYSE must consider any other factor the board deems relevant to the determination of whether an adviser is independent from management. While the compensation committee must consider these factors (including when engaging outside counsel to advise the committee) there is no requirement that the committee disclose the reasoning behind its decision whether to engage an adviser or that the adviser actually be independent from management.

What Companies Should Do Now

Now that the new listing rules have been approved by the SEC, listed companies should take the following steps:

- Review the specifics of the new listing rules applicable to them, including any applicable exemptions and transition periods.
- Begin the process of adopting a compensation committee charter or amending their current compensation committee charter to ensure that it complies with the applicable listing rules. The deadline for companies listed on NASDAQ to adopt a compensation committee charter is July 1, 2013.
- Consider revising Director and Officer Questionnaires to obtain additional information about members of the compensation committee and their relationships with the company, its subsidiaries and affiliates, including whether any members of the compensation committee receives consulting or other advisory fees from the company or its subsidiaries.
- Begin the process of gathering additional information from compensation committee advisers (including outside counsel) in order to evaluate their compliance with the Independence Factors. Companies should ensure that the information gathering and independence evaluation processes are properly documented and disclosed. To this end, companies may consider requesting representations regarding the Independence Factors from their compensation committee advisers.

Footnotes

1 A copy of the SEC release approving NYSE's new listing rules is available here. A copy of the SEC release approving NASDAQ's new listing rules is available here.

2 We previously summarized these proposals in our publication, dated October 19, 2012, entitled "Exchanges Propose Rules for Compensation Committees under Dodd-Frank: NASDAQ Issuers Face Heightened Requirements."

3 For those NASDAQ-listed companies that do not currently have a standing compensation committee, until such a committee is established, the rules governing compensation committees and the engagement of advisers will apply to the independent directors who determine (or recommend to the board for determination) the compensation of the company's executive officers.

4 For companies listed on the NYSE or NASDAQ, these factors are in addition to the independence requirements set forth Section 303A.02 of the NYSE Listed Company Manual and NASDAQ Rule 5605(a)(2), respectively.

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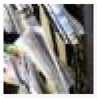

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