SEC Approves Changes to NYSE's and Nasdaq's Listing Standards Regarding Compensation Committees and Compensation Advisers

The Securities and Exchange Commission ("SEC") recently approved rule changes to the listing standards of the New York Stock Exchange LLC ("NYSE") and The NASDAQ Stock Market LLC ("Nasdaq") regarding independence of compensation committees and compensation advisers (the "Rule Changes").[1] These Rule Changes were necessary to comply with Section 952 of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act") and Rule 10C-1 of the Securities Exchange Act of 1934 ("Exchange Act").[2]

I. The NYSE's Rule Changes

The NYSE's Rule Changes will amend Section 303A.00, Section 303A.02 and Section 303A.05 of the NYSE Listed Company Manual ("Manual") concerning corporate governance, independence tests and compensation committees. The NYSE Rule Changes generally provide as follows:

- *Independence Requirements*. Compensation committee members of listed issuers will be required to satisfy additional independence requirements.[3] The Rule Changes provide that in affirmatively determining the independence of any director who will serve on the compensation committee of a listed company's board of directors ("Board"), the Board must consider all factors specifically relevant to determining whether that director has a relationship to the company which is material to the director's ability to be independent from management in connection with the duties of a compensation committee member, including, but not limited to (i) the source of the director's compensation, including any consulting, advisory or other compensatory fees paid by the listed company to such director and (ii) 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.[4]
    - The Rule Changes will also amend the relevant commentary to provide that the Board should consider (i) whether the director receives compensation from any person or entity that would impair his or her ability to make independent judgments with respect to the company's executive compensation and (ii) whether an affiliate relationship places the director under the direct or

[1] The SEC approved the Rule Changes on January 11, 2013. *See* SEC Release No. 34-68639; File No. SR-NYSE-2012-49 (approving the NYSE's Rule Changes), *available at* http://www.sec.gov/rules/sro/nyse/2013/34-68639.pdf; *see* SEC Release No. 34-68640; File No. SR-NASDAQ-2012-109 (approving Nasdaq's Rule Changes), *available at* http://www.sec.gov/rules/sro/nasdaq/2013/34-68640.pdf.

[2] The Dodd-Frank Act is *available at* http://www.govtrack.us/congress/billtext.xpd?bill=h111-4173. Section 952 of the Dodd-Frank Act added Section 10C to the Exchange Act. The SEC adopted Exchange Act Rule 10C-1 to implement Section 10C of the Exchange Act. For further discussion of Exchange Act Rule 10C-1, *see* our firm memorandum, *SEC Adopts Final Rules Regarding Compensation Committees and Compensation Advisors* (June 27, 2012), *available at* http://www.cahill.com/publications/firm-memoranda/1012960/_res/id=Attachments/index=0/CGR%20Memo%20-%20SEC%20Adopts%20Final%20Rules%20Regarding%20Compensation%20Committees%20and%20Compensation%20Advisers.pdf.

[3] The NYSE will retain its existing requirement that each listed company have a compensation committee composed entirely of independent directors (as defined in Section 303A.02(a)-(b) of the Manual).

[4] The NYSE declined to adopt any specific numerical tests with respect to these factors or to adopt a requirement to consider any other particular factors. In particular, the NYSE declined to adopt an absolute prohibition on a Board making an affirmative finding that a director is independent if the director or any of the director's affiliates own more than some specified percentage of the shares of the listed company.

indirect control of the listed company or its senior management, or creates a direct relationship between the director and members of senior management, such that the director's ability to make independent judgments regarding the company's executive compensation would be impaired.

- A cure period will be provided for listed issuers that fail to comply with the compensation committee composition requirements in situations where a member ceases to be independent for reasons outside of the member's reasonable control. Under such circumstances, so long as the compensation committee continues to have a majority of independent directors (as defined in Section 303A.02(a)-(b) of the Manual) and the listed company provides prompt notice to the NYSE, the non-independent member may remain on the compensation committee until the earlier of (i) the next annual shareholders' meeting or (ii) one year from the occurrence of the event that caused the member to no longer be independent.

- *Compensation Advisers*. Listed companies will be required to provide their compensation committees with specific rights and responsibilities concerning compensation advisers, as mandated by Exchange Act Rule 10C-1(b)(2)-(4) (the "New Rights and Responsibilities"),[5] and will also be required to specify these New Rights and Responsibilities in their compensation committee charters. The New Rights and Responsibilities include that:

  - the compensation committee may, in its sole discretion, retain or obtain the advice of compensation consultants, independent legal counsel or other advisers (collectively, "compensation advisers"),[6]

  - the compensation committee is directly responsible for the appointment, compensation and oversight of the work of any compensation adviser retained by the compensation committee,

  - the listed company must provide for appropriate funding, as determined by the compensation committee, for payment of reasonable compensation to any compensation adviser retained by the compensation committee, and

  - with certain exceptions, the compensation committee may select, or receive advice from, a compensation adviser only after taking into consideration all factors relevant to that person's independence from management, including the following specific factors ("Independence Factors"):[7]

    (A) The provision of other services to the listed company by the person that employs the compensation adviser;

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[5] The New Rights and Responsibilities will be set forth in NYSE Manual Section 303A.05(c)(i)-(iv).

[6] Exchange Act Rule 10C-1(b)(4) does not include the word "independent" before "legal counsel," and Nasdaq has deleted the word "independent" before "legal counsel" in its Listing Rule 5605(d) and IM-5605-6, which correspond to the provisions set forth in NYSE Manual Section 303A.05(c)(i)-(iv). Therefore, for purposes of this memorandum, "compensation adviser" shall be defined as "compensation consultant, legal counsel or other adviser" in all instances other than when reference is being made to NYSE Manual Section 303A.05(c)(i)-(iii), in which case "compensation adviser" shall be defined as "compensation consultant, independent legal counsel or other adviser."

[7] These are the same six independence factors identified by the SEC in Exchange Act Rule 10C-1(b)(4). Because Exchange Act Rule 10C-1(b)(4) does not include the word "independent" prior to "legal counsel," Exchange Act Rule 10C-1(b)(4) is understood to require an independence assessment is required for any legal counsel to a compensation committee, other than in-house legal counsel.

(B) The amount of fees received from the listed company by the person that employs the compensation adviser, as a percentage of such person's total revenue;

(C) The policies and procedures of the person that employs the compensation adviser that are designed to prevent conflicts of interest;

(D) Any business or personal relationship of the compensation adviser with a member of the compensation committee;

(E) Any stock of the listed company owned by the compensation adviser; and

(F) Any business or personal relationship of the compensation adviser or the person employing the adviser with an executive officer of the listed company.

The commentary to these Rule Changes will further provide as follows:

- Nothing in the Rule Changes should be construed (i) to require the compensation committee to implement or act consistently with the advice or recommendations of the compensation adviser or (ii) to affect the ability or obligation of the compensation committee to exercise its own judgment in fulfilling its duties;

- A compensation committee is not required to conduct an independence assessment before selecting, or obtaining advice from, (i) in-house legal counsel or (ii) any compensation adviser whose role is limited to: (a) consulting on any broad-based plan that does not discriminate in scope, terms or operation in favor of executive offers or directors of the listed company, and that is available generally to all salaried employees or (b) providing information that either is not customized for a particular company or that is customized based on parameters that are not developed by the consultant, and about which the consultant does not provide advice;[8] and

- The Rule Changes do not require a compensation committee to only select or receive advice from independent compensation advisers; rather, a compensation committee may select or receive advice from any compensation adviser it prefers, including one that is not independent, so long as the compensation committee first considers the six Independence Factors.

- *Exemptions*. Each category of issuer that qualifies for a general or specific exemption under Exchange Act Rule 10C-1 or the NYSE's existing compensation-related listing rules will also be exempt from the Rule Changes. Thus, (i) controlled companies, (ii) "smaller reporting companies" (*i.e.*, companies with a public float of less than $75 million), (iii) limited partnerships, (iv) companies in bankruptcy, (v) closed-end and open-end management investment companies registered under the Investment Company Act of 1940, (vi) passive business organizations in the form of trusts or derivatives and special purpose securities, (vii) issuers whose only listed equity security is a preferred stock, and (viii) foreign private issuers that follow home country practice in lieu of having an independent compensation committee and disclose in their annual report filed with the SEC any significant ways in

[8] No disclosure is required under Item 407(e)(3)(iii) of Regulation S-K with respect to these types of services.

which their corporate governance practices differ from those followed by domestic companies under NYSE listing standards will be exempt from the Rule Changes.[9]

- *Effectiveness of Rule Changes*. Listed companies will have until the earlier of (i) their first annual meeting after January 15, 2014 or (ii) October 31, 2014, to comply with the enhanced compensation committee director independence standards. Existing compensation committee independence standards will continue to apply pending the transition to the new independence standards. The other Rule Changes, which relate to the New Rights and Responsibilities of compensation committees, including the requirement that they conduct an independence assessment before selecting or receiving advice from most types of compensation advisers, will become effective on July 1, 2013 for currently listed issuers that are not otherwise exempt.

- *Phase-In for Certain Categories of Issuers*. Certain categories of issuers, however, will be allowed to phase-in compliance with respect to the Rule Changes:

  - Companies listing in conjunction with their initial public offerings ("IPOs"),[10] companies listing in connection with a spin-off or carve-out, companies listing upon emergence from bankruptcy and companies that cease to qualify as controlled companies will be eligible for the following transition period with respect to the enhanced independence standards (concerning fees and affiliations) for directors serving on the compensation committee:[11]

    (i) by the company's listing date, the compensation committee must contain at least one independent member that meets the enhanced standards;

    (ii) within 90 days of the listing date, the compensation committee must contain at least a majority of independent members that meet the enhanced standards; and

    (iii) within one year of the listing date, all members of the compensation committee must meet the enhanced standards.

[9] "Controlled company" refers to a listed company in which more than 50% of the voting power for the election of directors is held by an individual, a group or another company; "limited partnership" refers to a form of business ownership and association consisting of one or more general partners who are fully liable for the debts and obligations of the partnership and one or more limited partners whose liability is limited to the amount invested; "open-end management investment company" refers to an investment company, other than a unit investment trust or face-amount certificate company, that offers for sale or has outstanding any redeemable security of which it is the issuer; "closed-end management investment company" refers to any management investment company other than an open-end management investment company; "foreign private issuer" refers to any foreign issuer other than a foreign government, except for an issuer that has more than 50% of its outstanding voting securities held of record by U.S. residents and any of the following: a majority of its officers and directors are citizens or residents of the U.S., more than 50% of its assets are located in the U.S. or its business is principally administered in the U.S.

[10] For purposes of the Rule Changes, a company is considered to be listing in conjunction with an initial public offering if, immediately prior to listing, it does not have a class of common stock registered under the Exchange Act.

[11] The NYSE's existing rules permit these categories of issuers to phase-in compliance with all of the NYSE's applicable independence requirements for compensation committees after the date that the issuer's securities first trade on the NYSE. Current compliance periods for these categories of issuers will be preserved with respect to the Rule Changes regarding the enhanced independence standards for compensation committee members regarding fees and affiliations.

o Companies that cease to qualify as foreign private issuers will have a transition period of six months before which they must have a fully independent compensation committee where all members meet the enhanced independence standards;

o Companies listing upon transfer from another market will have one year from the listing date to satisfy all the requirements of the Rule Changes; and

o Companies that were, but have ceased to be, smaller reporting companies will have six months from the date that they cease to be a smaller reporting company ("Start Date") to comply with the Rule Changes requiring compensation committees to consider the Independence Factors before selecting compensation advisers.[12] In addition, such companies will be permitted to phase in compliance with the enhanced independence requirements for compensation committee members relating to compensatory fees and affiliation as follows:

(i) one member must satisfy the requirements by six months from the Start Date;

(ii) a majority of members must satisfy the requirements by nine months from the Start Date; and

(iii) all members must satisfy the requirements by one year from the Start Date. During the compliance schedule, companies that have ceased to be smaller reporting companies will be required to comply with the NYSE listing rules that have previously been applicable to them.

II. Nasdaq's Rule Changes

Nasdaq's Rule Changes will amend (i) Nasdaq Rules 5605 and 5615 concerning Boards, committees and corporate governance requirements and (ii) other Nasdaq listing rules regarding compensation committees. Nasdaq's Rule Changes generally provide as follows:

- *Requirement for an Independent Compensation Committee*. Listed companies will be required to have a standing compensation committee consisting of at least two members, each of whom must be an independent director (as defined in Nasdaq Rule 5605(a)(2)), and each of whom will be subject to the following additional independence requirements:[13]

(i) Compensation committee members will not be permitted to accept, directly or indirectly, any consulting, advisory or other compensatory fee, other than for (a) membership on the committee,

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[12] Pursuant to Rule 12b-2 under the Exchange Act, a company tests its status as a smaller reporting company on an annual basis as of the last business day of its most recently completed second fiscal quarter. A company with a public float of $75 million or more as of this date will cease to be a smaller reporting company as of the beginning of the following fiscal year. Under the NYSE's and Nasdaq's Rule Changes, the day of this change in status is the beginning of the compliance phase-in period.

[13] Nasdaq's current listing rules do not impose size requirements on any Board committees, other than audit committees, and require that compensation of a company's executive officers must be determined, or recommended to the Board for determination, either by: (i) a compensation committee comprised solely of independent directors; or (ii) by a majority of the Board's independent directors in a vote in which only independent directors participate ("Alternative Option"). The Rule Changes eliminate the Alternative Option.

on the Board, or on any other Board committee or (b) fixed amounts of compensation under a retirement plan (including deferred compensation) for prior service with the company, provided that such compensation is not contingent on continued service;[14] and

(ii) 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 of the company or an affiliate of a subsidiary of the company in order to determine whether such affiliation would impair the director's judgment as a member of the compensation committee.[15]

- A cure period will be provided for listed issuers who fail to comply with the compensation committee composition requirements due to one vacancy, or if one compensation committee member ceases to be independent due to circumstances beyond the member's reasonable control. Pursuant to the Rule Changes, a company must regain compliance by the earlier of (i) the next annual shareholders' meeting or (ii) one year from the occurrence of the event that caused the noncompliance. If the annual shareholders' meeting occurs no later than 180 days following the event that caused the noncompliance, however, the company will instead have 180 days from that event to regain compliance. A company relying on this provision must provide notice to Nasdaq immediately upon learning of the event or circumstance that caused the noncompliance.[16]

- Listed companies may continue to rely on Nasdaq's existing exception that allows a non-independent director to be appointed to a compensation committee and serve for up to two years under exceptional and limited circumstances, so long as that director is not currently an executive officer, an employee or a family member of an executive officer.[17] The exception applies, however, only if the committee is comprised of at least three members and the company's Board determines that the individual's membership on the committee is required by the best interests of the company and its shareholders. A company that relies on this exception must disclose, either on or through the company's website, or in their proxy statement for the next annual meeting subsequent to such determination (or, if the company does not file a proxy, in its Form 10-K or 20-F), the nature of the relationship and the reasons for the determination. In addition, the company must provide any disclosure required by Instruction 1 to Item 407(a) of Regulation S-K regarding its reliance on this exception.

- *Charter*. Listed companies will be required to certify that they have adopted a written compensation committee charter and that the compensation committee will review and reassess the adequacy of the

[14] This is the same standard that applies to audit committee members under Exchange Act Rule 10A-3. In addition, there will be no "look-back" period, so the prohibition on the receipt of any consulting, advisory or other compensatory fee by a compensation committee member will begin with the member's term of service on the compensation committee.

[15] Although the Rule Changes will require a Board to consider affiliation in making an eligibility determination for compensation committee members, the Rule Changes will not prohibit a Board from permitting a director who is an affiliate to serve on the compensation committee. In performing its independence analysis, a Board is not required to apply a "look-back" period, and is therefore required to consider affiliation only with respect to relationships that occur during an individual's term of service as a compensation committee member.

[16] This cure period is the same as the cure period currently provided in Nasdaq's listing rules for noncompliance with the requirement to have a majority-independent Board.

[17] Nasdaq's existing rules for audit committees and nomination committees also include such an exception.

charter on an annual basis.[18] The Rule Changes will require the compensation committee charter to specify:

(i) The scope of the compensation committee's responsibilities and how it carries out those responsibilities, including structure, processes and membership requirements;

(i) The compensation committee's responsibility for determining, or recommending to the Board for determination, the compensation of the company's chief executive officer ("CEO") and all other executive officers;

(ii) That the CEO of the company may not be present during voting or deliberations by the compensation committee on his or her compensation;[19] and

(iii) The compensation committee's New Rights and Responsibilities required by Exchange Act Rule 10C-1, including the responsibility to consider the six Independence Factors before selecting, or receiving advice from, a compensation adviser.

The Rule Changes further provide, however, that compensation committees will not be required to conduct an independence assessment before selecting, or receiving advice from, (i) in-house legal counsel or (ii) a compensation adviser that acts in a role limited to: (a) consulting on any broad-based plan that does not discriminate in scope, terms, or operation, in favor of executive officers or directors of the company, and that is available generally to all salaried employees; and/or (b) providing information that either is not customized for a particular issuer or that is customized based on parameters that are not developed by the adviser, and about which the adviser does not provide advice. The Rule Changes also provide that compensation committees may select, or receive advice from, any compensation adviser they prefer, including ones that are not independent, so long as they first consider the Independence Factors. In addition, the Rule Changes state that nothing in Rule 5605(d)(3) should be construed: (i) to require a compensation committee to implement or act consistently with the advice or recommendations of the compensation adviser; or (ii) to affect the ability or obligation of a compensation committee to exercise its own judgment in fulfillment of the duties of the compensation committee.

- *Exemptions*. Asset-backed issuers and other passive issuers, cooperatives, limited partnerships, management investment companies and controlled companies that are exempt from Nasdaq's existing compensation-related listing rules will also be exempt from the Rule Changes. In addition, foreign private issuers will still be allowed to follow their home country practice in lieu of the Rule Changes relating to compensation committees, so long as they disclose in their annual reports filed with the SEC each requirement that they do not follow and describe the home country practice they follow instead. However, with respect, specifically, to the enhanced standards of independence for compensation committees concerning fees received by members and member affiliations, the Rule Changes require that

[18] This Rule Change is similar to Nasdaq's current requirement for companies to certify as to the adoption of a written audit committee charter, except that the requirement for annual review and reassessment of the adequacy of the compensation committee charter is written prospectively, rather than retrospectively (*i.e.,* the compensation committee charter requirement states that the compensation committee *will review and reassess* the adequacy of the charter on an annual basis, while the current audit committee charter requirement states that the audit committee *has reviewed and reassessed* the adequacy of the charter on an annual basis).

[19] This requirement is based upon Nasdaq's current compensation-related listing rules. *See* Nasdaq Rule 5605(d)(1).

if a listed foreign private investor follows its home country practice instead, then it must additionally disclose in its annual report filed with the SEC the reasons why it does not have such a committee.

- Smaller reporting companies will be required to have, and to certify that they have and will continue to have, a compensation committee comprised of at least two independent directors and a written compensation committee charter or Board resolution that specifies the committee's responsibilities and authority,[20] but such companies will not be required to adhere to the enhanced independence standards for members of compensation committees relating to compensatory fees and affiliation. In addition, smaller reporting companies will not be required to include in their compensation committee charter or Board resolution a grant of New Rights and Responsibilities to the compensation committee.

• *Effectiveness of Rule Changes*. The Rule Changes which relate to the New Rights and Responsibilities of compensation committees, including the requirement that they conduct an independence assessment before selecting or receiving advice from most types of compensation advisers, will become effective on July 1, 2013. To the extent that a company does not yet have a compensation committee by that date, the provisions of these particular Rule Changes will apply to the independent directors who determine, or recommend to the Board for determination, the compensation of the CEO and all other executive officers of the company. Listed companies will have until the earlier of: (i) their first annual meeting after January 15, 2014 or (ii) October 31, 2014, to comply with the remaining Rule Changes. Until a Company is required to comply with a particular provision of the Rule Changes, it must continue to comply with the corresponding provision, if any, of Nasdaq's existing listing rules.

- Listed companies will be required to certify to Nasdaq, no later than 30 days after the final implementation deadline applicable to them, that they have complied with the Rule Changes in Rule 5605(d) regarding compensation committees. Nasdaq will provide companies with the relevant form for this certification through Nasdaq's Listing Center website prior to the effective date of the Rule Changes.

• *Phase-In for Certain Categories of Issuers*. Certain categories of issuers, however, will be allowed to phase-in compliance with respect to the Rule Changes:[21]

- Companies listing on Nasdaq in connection with an IPO, companies emerging from bankruptcy and companies ceasing to be controlled companies will be permitted to phase in their compliance with the Rule Changes requiring that compensation committees have at least two members, that these members be independent directors and that they meet the enhanced standards of independence for compensation committees concerning fees received by members and member affiliations. The phase-in compliance schedule for these companies will be as follows: (i) the compensation committee must have one independent member at the time of listing, (ii) the compensation committee must have a majority of independent members within 90 days of listing; and (iii) all committee members must be independent within one year of listing; and

[20] Unlike other companies, smaller reporting companies may include this content in a Board resolution, rather than a compensation committee charter. In addition, smaller reporting companies will not be required to review and reassess the adequacy of the charter or Board resolution on an annual basis.

[21] None of the phase-in schedules apply to the requirement to adopt a written compensation committee charter containing the content specified in the Rule Changes.

- Companies that were, but have ceased to be, smaller reporting companies will have six months from the Start Date to comply with the Rule Changes relating to the compensation committee's New Rights and Responsibilities. In addition, companies that were, but have ceased to be, smaller reporting issuers will have six months from the Start Date to certify to Nasdaq that (i) they have complied with the requirement to adopt a written compensation committee charter, including the content specified in the Rule Changes and (ii) they have complied, or within the applicable phase-in schedule will comply, with the additional Rule Changes regarding compensation committee composition. The Rule Changes also allow companies that were, but have ceased to be, smaller reporting companies to phase in compliance with the enhanced independence requirements for compensation committee members relating to compensatory fees and affiliation as follows:

  (i) one member must satisfy the requirements within six months from the Start Date;

  (ii) a majority of members must satisfy the requirements within nine months from the Start Date; and

  (iii) all members must satisfy the requirements within one year from the Start Date.

- Since smaller reporting companies are required to have compensation committees comprised of at least two independent directors, a company that has ceased to be a smaller reporting company will not be permitted to use the phase-in schedule for these requirements. Thus, during the phase-in schedule, a company that has ceased to be a smaller reporting company must continue to comply with the requirement to have a compensation committee comprised of at least two independent directors.

- No changes will be made to the phase-in schedule for companies transferring to Nasdaq from other markets. Companies transferring from other markets with a substantially similar requirement will be afforded the balance of any grace period afforded by the other market. Companies transferring from other listed markets that do not have a substantially similar requirement will be afforded one year from the date of listing on Nasdaq to comply with the compensation committee composition requirements.

In light of the July 1, 2013 effective date for most of the Rule Changes, companies are encouraged to review their existing compensation committee charters, or commence the drafting process if they do not already have a charter, in order to ensure compliance with the New Rules. In addition, insofar as the Rule Changes will require compensation committees to consider the Independence Factors before selecting or receiving advice from most types of compensation advisers, compensation committees may wish to pre-clear or conduct an independence assessment of their advisers in advance of the July 1st effective date of those Rule Changes.

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If you have any questions about the issues addressed in this memorandum or if you would like a copy of any of the materials mentioned, please do not hesitate to call or email Charles A. Gilman at 212.701.3403 or cgilman@cahill.com; Jon Mark at 212.701.3100 or jmark@cahill.com; John Schuster at 212.701.3323 or jschuster@cahill.com; Glenn Waldrip at 212.701.3110 or gwaldrip@cahill.com; or Abigail Darwin at 212.701.3240 or adarwin@cahill.com.