

SEC Approves Compensation Committee Listing Standards

The U.S. Securities and Exchange Commission has approved the compensation committee listing standards contemplated by the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act).¹ The new listing standards establish independence requirements for compensation committee members and require compensation committees to consider factors relevant to potential conflicts of interests on the part of compensation consultants, legal advisers and other compensation advisers.

In June 2012, the SEC adopted Rule 10C-1 under the Securities Exchange Act of 1934 to implement the Dodd-Frank Act requirement for listing standards relating to compensation committees, addressing both compensation committee independence and compensation committee assessment of the independence of compensation consultants, legal counsel or other advisers.² In accordance with Rule 10C-1, the New York Stock Exchange, the Nasdaq Stock Market and other stock exchanges submitted proposed amendments to their respective listing standards to the SEC for review last fall; the exchanges subsequently proposed further amendments. After taking into account public comments that were submitted on the proposed listing standards, the SEC approved the revised listing standards, as amended.

Although the final NYSE and Nasdaq rules are similar in many respects, we discuss each in separate sections below, concluding with our

practical considerations section at the end of this Legal Update.

NYSE Listing Standards

Compensation Committee Independence Requirements. The NYSE has added new subsection (ii) to Section 303A.02(a) of the NYSE listed company manual to address the enhanced independence requirements for compensation committee members. Once this rule becomes effective, in addition to generally affirmatively determining the independence of any director who will serve on the compensation committee, the board of directors must consider:

all factors specifically relevant to determining whether a director has a relationship to the listed company which is material to that director's ability to be independent from management in connection with the duties of a compensation committee member, including, but not limited to:

- A. the source of compensation of such director, including any consulting, advisory or other compensatory fee paid by the listed company to such director; and
- B. whether such director is affiliated with the listed company, a subsidiary of the listed company or an affiliate of a subsidiary of the listed company.

With respect to compensation, the accompanying commentary makes clear that the board "should consider whether the director

receives compensation from any person or entity that would impair his ability to make independent judgments about the listed company's executive compensation." The rules do not expressly require consideration of indirect compensation, such as compensation paid to a family member or to a related entity, but such compensation may need to be considered to the extent that it is relevant to determining whether a director has a relationship that is material to his or her ability to be independent from management. Unlike the Nasdaq rules discussed below, the NYSE listing rules do not make receipt of compensation a bar to serving on the compensation committee if the board is satisfied that such director meets the requirements for independence.

Similarly, affiliate status is not a bar to compensation committee independence under the NYSE listing standards. The commentary directs boards of directors to consider whether an affiliate relationship places a director under the direct or indirect control of the company or its senior management—or creates a direct relationship between the director and members of senior management—of a nature that would impair the director's ability to make independent judgments about the listed company's executive compensation.

Rights and Responsibilities with Respect to Compensation Advisers. The NYSE added new subsection (c) to Section 303A.05 of the NYSE listed company manual to specify the rights and responsibilities of the compensation committee with respect to compensation advisers, which now must be addressed in the compensation committee charter. These provisions give the compensation committee the sole discretion to retain or obtain the advice of a compensation consultant, independent legal counsel or other adviser. When the compensation committee retains such an adviser, it is directly responsible for appointing, compensating and overseeing the adviser's work. The company must provide for appropriate

funding, as determined by the compensation committee, for payment of reasonable compensation to an adviser retained by the compensation committee.

The compensation committee may select a compensation consultant, legal counsel or other adviser only after considering all factors relevant to independence from management, including the following:

- The provision of other services to the company by the person that employs the compensation adviser;
- The amount of fees received from the company by the employer of the adviser, as a percentage of the total revenue of such employer;
- The policies and procedures of the adviser's employer that are designed to prevent conflicts of interest;
- Any business or personal relationship of the adviser with a member of the compensation committee;
- Any stock of the company owned by the adviser; and
- Any business or personal relationship of the adviser or the adviser's employer with an executive officer of the company.

The NYSE listing standard requires consideration of *all* factors relevant to compensation adviser independence, not just the six factors enumerated above. If there is a circumstance that is relevant to determining whether a compensation adviser is independent from management, the compensation committee would need to consider it, regardless of whether it is included among the specific factors mentioned in the listing standards.

The compensation committee is required to conduct the independence assessment for any compensation consultant, legal counsel or other adviser that provides advice to the compensation committee, other than:

- In-house legal counsel; and

- Any compensation consultant, legal counsel or other adviser whose role is limited to
 - 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
 - providing information that either is not customized for a particular company 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.

When adopting Rule 10C-1, the SEC emphasized that compensation committees are required to conduct this conflict of interest assessment with respect to any compensation advisers (other than inside legal counsel) that provide advice to the compensation committee, regardless of who retained the adviser.

In its order approving the NYSE’s amended listing standards, the SEC stated that it “anticipates that compensation committees will conduct such an independence assessment at least annually.”

The NYSE commentary makes clear that the listing standards relating to compensation advisers do not require the compensation committee to act consistently with the advice or recommendation of any compensation adviser. Furthermore, the commentary states that the new listing standards do not require a compensation adviser to be independent. The requirement is that the compensation committee consider the enumerated independence factors before selecting or receiving advice from a compensation adviser. However, after considering these independence factors, the compensation committee may select or receive advice from any compensation adviser it prefers, including ones that are not independent.

Effective Dates. The amended NYSE listing standards become effective on July 1, 2013. However, NYSE listed companies do not have to comply with the new compensation committee independence requirements until the earlier of their first annual meeting after January 15, 2014, or October 31, 2014.

Opportunity to Cure. The NYSE listing standards permit a member of a compensation committee who ceases to be independent for reasons outside his or her reasonable control to remain a member of the compensation committee until the earlier of the next annual shareholders’ meeting or one year from the occurrence of the event that caused the member to be no longer independent. To avail itself of this cure period, prompt notice must be given by the issuer to the NYSE regarding such non-compliance with the compensation committee listing standard. In addition, this right to cure is available only if a majority of the members of the compensation committee continue to be independent.

Foreign Private Issuers. The NYSE permits foreign private issuers to follow their home country practices in lieu of particular NYSE corporate governance listing standards. The NYSE did not add any additional disclosure requirements specific to the new compensation committee standards beyond the requirement already generally applicable when foreign private issuers follow home country practice. An issuer relying on home country practice with respect to compensation committees must disclose in its annual report filed with the SEC any significant ways in which its corporate governance practices differ from those followed by domestic companies under NYSE listing standards.

Initial Public Offerings. A company listing on the NYSE in conjunction with its initial public offering is permitted a transition period to comply with compensation committee independence requirements. The compensation committee must have at least one independent

member who meets the enhanced independence standards relating to receipt of fees and affiliate status by the listing date. The compensation committee must have at least a majority of independent members who meet the enhanced independence standards within 90 days of the listing date. Within one year of its listing date, all members of the compensation committee must meet the enhanced independence standards.

Smaller Reporting Companies. The NYSE does not require smaller reporting companies to comply with either the enhanced compensation committee independence standards relating to compensatory fees and affiliation or with the new requirement to consider compensation adviser independence factors. Smaller reporting companies are required to comply with other portions of the compensation committee listing standards, including those standards concerning the compensation committee's authority, responsibility and funding of compensation advisers.

Exemptions. The NYSE's existing exemptions from compensation-related listing rules also apply to its new compensation committee requirements. As a result, the following issuers are exempt from the amended compensation committee listing standards: controlled companies; limited partnerships; companies in bankruptcy; management investment companies that are registered under the Investment Company Act of 1940; passive business organizations in the form of trusts or derivatives and special purpose securities; and issuers whose only listed equity stock is preferred stock.

The full text of the NYSE amended listing standards is available at

<http://www.sec.gov/rules/sro/nyse/2013/34-68639-ex5.pdf>.

NASDAQ Listing Standards

Nasdaq Compensation Committee

Requirements. Nasdaq does not currently require its listed companies to have a separate

compensation committee—Nasdaq listing rules have permitted executive compensation to be determined, or recommended to the board of directors, by a compensation committee consisting solely of independent directors or by independent directors constituting a majority of the board, with only independent directors voting. Under amended Rule 5605(d), Nasdaq is requiring listed companies to have a standing compensation committee, with a minimum of two members, each of whom are independent directors. The new listing rules also contain requirements for the charter of the compensation committee.

Compensation Committee Independence.

In addition to satisfying the general Nasdaq rules for director independence, Rule 5605(d)(2)(A) of the Nasdaq listing standards prohibits compensation committee members from accepting “directly or indirectly any consulting, advisory or other compensatory fee” from the company or any of its subsidiaries. For this purpose, compensatory fees do not include fees received as a director or board committee member or fixed amounts under a retirement plan for prior service (as long as such compensation is not contingent upon continued service). Nasdaq's position with respect to receipt of compensation is similar to the requirement of Rule 10A-3 with respect to audit committees, but differs from what is required for compensation committees by Rule 10C-1 or by the comparable NYSE listing standard.

Under Rule 5605(d)(2)(A), the board also will have to consider whether a director is affiliated with the company, a subsidiary of the company or an affiliate of a subsidiary of the company to determine whether such affiliation would impair the director's judgment as a member of the compensation committee. However, affiliate status will not bar a determination of independence for a compensation committee member.

Rights and Responsibilities with Respect to Compensation Advisers. Rule 5605(d)(3) gives the compensation committee the sole

discretion to retain or obtain the advice of a compensation consultant, legal counsel or other adviser. It provides that the compensation committee is directly responsible for appointing, compensating and overseeing the work of any compensation consultant, legal counsel and other adviser it retains. The company must provide for appropriate funding, as determined by the compensation committee, for payment of reasonable compensation to a compensation consultant, legal counsel or any other adviser retained by the compensation committee.

Rule 5605(d)(3)(D) provides that the compensation committee may select, or receive advice from, a compensation consultant, legal counsel or other adviser to the compensation committee, other than in-house legal counsel, only after considering the following factors:

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

Unlike the corresponding NYSE listing standard, Nasdaq only requires consideration of the six enumerated factors, without any requirement to consider any additional factors that might be relevant to compensation adviser independence.

The compensation committee is required to conduct the independence assessment with respect to any compensation adviser that

provides advice to the compensation committee, other than in-house legal counsel. However, no independence assessment is required with respect to a compensation adviser that solely consults on any broad-based plan that does not discriminate in favor of executive officers or directors and that is available generally to all salaried employees, or that provides information that either is not customized for a particular issuer or is customized based on parameters that are not developed by the adviser, and about which the adviser does not provide advice.

When adopting Rule 10C-1, the SEC emphasized that compensation committees are required to conduct this conflict of interest assessment with respect to any compensation advisers (other than inside legal counsel) that provide advice to the compensation committee, regardless of who retained the adviser.

In its order approving the Nasdaq listing standards, the SEC stated that it “anticipates that compensation committees will conduct such an independence assessment at least annually.”

The compensation committee is not required to implement or act consistently with the advice or recommendations of any adviser. Nothing in the rule requires a compensation adviser to be independent; the rule only requires that the compensation committee consider the enumerated independence factors before selecting or receiving advice from a compensation adviser. After considering these independence factors, the compensation committee may select or receive advice from any compensation adviser it prefers, including ones that are not independent.

Opportunity to Cure. The Nasdaq listing standards provide a cure period if a company fails to comply with the compensation committee composition requirement due to one vacancy, or where one compensation committee member ceases to be independent due to circumstances beyond the member's reasonable control. In such cases, the company has until the

earlier of its next annual shareholders meeting or one year from the occurrence of the event that caused the failure to comply with this requirement to regain compliance. If the annual shareholders meeting occurs no later than 180 days following the event that caused the failure to comply with this requirement, Nasdaq allows the company 180 days from such event to regain compliance. In order to rely on this cure period, the company must provide Nasdaq notice of non-compliance with the compensation committee listing standards immediately upon learning of the event or circumstance that caused the noncompliance.

Foreign Private Issuers. Foreign private issuers are allowed to rely on home country practices and disclose the differences between those practices and the listing standards. If a foreign private issuer follows home country practice rather than having an independent compensation committee, it must disclose in its annual reports filed with the SEC the reasons why it does not have such an independent compensation committee.

Initial Public Offerings. A company listing on Nasdaq in connection with its initial public offering would be permitted to phase-in its compliance with the requirements that a compensation committee have at least two members, that these members be independent directors as defined in Nasdaq's rules and that they meet the enhanced standards of independence for compensation committees (concerning receipt of fees and affiliate status). At the time of listing, the compensation committee must have one independent member. A majority of the members of the compensation committee must be independent within 90 days of listing. All members of the compensation committee must be independent within one year of listing.

Smaller Reporting Companies. Smaller reporting companies are required to have a compensation committee consisting of two members who must be independent directors.

However, the members of compensation committees of smaller reporting companies do not have to adhere to the enhanced independence factors added by the new listing standard. Although a smaller reporting company must include provisions in the committee's charter or board resolutions specifying the responsibilities as set forth in Rule 5605(d)(1)(A)-(C), such document is not required to include the specific compensation committee responsibilities and authority set forth in Rule 5605(d)(3), including the compensation adviser independence assessment.

Exemptions. Nasdaq has applied its existing exemptions from compensation-related listing rules to the new compensation committee listing standards. These include exemptions for asset-backed issuers and other passive issuers, cooperatives, limited partnerships, management investment companies registered under the Investment Company Act of 1940 and controlled companies.

Effective Dates. Nasdaq companies have until July 1, 2013 to comply with the provisions of the listing standards relating to (i) the authority of a compensation committee to retain compensation consultants, legal counsel and other compensation advisers, (ii) the funding of such advisers and (iii) the compensation committee's responsibility to assess the conflict of interest factors relating to such compensation advisers. If the company does not have a compensation committee by that date, these requirements will apply to the independent directors who determine, or recommend to the board for determination, executive officer compensation. Nasdaq companies must comply with the remaining provisions, including the compensation committee independence requirements, by the earlier of their first annual meeting after January 15, 2014, or October 31, 2014. Companies must certify their compliance to Nasdaq not later than 30 days after the applicable final implementation date.

The full text of the Nasdaq amended listing standards is available at <http://www.sec.gov/rules/sro/nasdaq/2013/34-68640-ex5.pdf>.

Practical Considerations

Listed companies should begin assessing whether the members of their compensation committees will satisfy the enhanced independence standards of the amended listing requirements. If not, they will need to prepare for changes to compensation committee membership to be in effect before the applicable 2014 deadline.

Listed companies also need to review their compensation committee charters and any other documents addressing director independence, such as corporate governance guidelines or categorical standards of independence, to determine if any modifications are necessary to reflect the amended listing standards. Because these changes typically require board approval, a review of these governance documents should be added to the agenda for a board meeting prior to July 1, 2013.

Listed companies should identify which compensation consultants, legal advisers and other advisers have been retained by, or otherwise provide advice to, the compensation committee. Companies should implement procedures to gather the necessary information to permit the compensation committee to make the required independence determinations with respect to these advisers. For example, companies may want to develop questionnaires to submit to existing and prospective compensation advisers for completion, based on the enumerated independence factors.

Compensation committees should make their compensation adviser independence determinations prior to July 1, 2013 with respect to continuing compensation advisers, as well as any prospective compensation adviser of which they are aware. Companies should add this

assessment to their corporate calendars so that it will be performed on an ongoing basis for compensation advisers that regularly provide advice to the compensation committee. The SEC has stated its expectation that such assessments will occur annually. In the future companies should also consider performing this assessment at, or before, the time when new compensation advisers are retained that will be providing advice to the compensation committee.

Although compensation committees have until July 1, 2013 to comply with the listing standards requiring assessments of compensation adviser independence, public companies must remember that there is a related disclosure requirement applicable to the current proxy season. If any compensation consultant whose work must be disclosed in the proxy statement has an actual conflict of interest, the proxy statement must disclose the nature of such conflict and how the conflict is being addressed. In determining whether a conflict of interest exists for disclosure purposes, companies are directed to consider the same enumerated factors that compensation committees must consider when selecting or receiving advice from compensation consultants.³

To the extent that a compensation committee has an engagement letter or agreement with any compensation adviser it has retained, such document should be reviewed to confirm that it does not conflict with the requirement that the compensation committee has the direct responsibility to appoint, compensate and oversee the work of such adviser.

Appropriate revisions should be added to director and officer questionnaires—or a special supplement could be prepared—to gather information relevant to compensation committee member independence and compensation consultant independence.

Nasdaq companies that do not have separate compensation committees should begin planning for this new compensation committee

requirement by identifying potential compensation committee members and drafting the appropriate committee charter.

Nasdaq companies must certify their compliance with the new listing standards to Nasdaq not later than 30 days after the earlier of their first annual meeting after January 15, 2014, or October 31, 2014. Nasdaq companies should add this certification requirement to their corporate calendars.

Nasdaq and NYSE listed companies should explain the new compensation committee listing requirements to their boards of directors and compensation committees.

If you have any questions regarding the new compensation committee listing standards, please contact the author of this Legal Update, Laura D. Richman, at +1 312 701 7304, or any of the lawyers listed below or any other member of our Corporate & Securities group or our Employment & Benefits group.

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Endnotes

¹ For the SEC's order relating to the NYSE listing standards see www.sec.gov/rules/sro/nyse/2013/34-68639.pdf; for the SEC's order relating to the Nasdaq listing standards see <http://www.sec.gov/rules/sro/nasdaq/2013/34-68640.pdf>.

² For more information about Rule 10C-1, see our June 28, 2012, Legal Update, "SEC Adopts Compensation Committee Listing Standards and Compensation Consultant Disclosure Rules," available at http://www.mayerbrown.com/files/Publication/942219b4-f6e3-4489-9c26-4aa022d157f6/Presentation/PublicationAttachment/fb4d287d-9cd6-4431-87c9-9e7c80604020/SEC_Listing_Standards_702510905_1.pdf.

³ See Item 407(e)(3)(iv) of Regulation S-K. For further discussion, see our Legal Update referenced in note 2.

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