

## *NYSE and NASDAQ Issue FINAL Listing Rule Changes for Compensation Committees and Compensation Advisers*

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### INTRODUCTION

On January 11, 2013, the New York Stock Exchange (“NYSE”) and The NASDAQ Stock Market LLC (“NASDAQ”) finalized changes<sup>1</sup> to their listing standards addressing compensation committee independence and committee responsibilities when selecting compensation consultants, outside legal counsel, and other advisers. These listing standard changes were required to comply with the SEC’s adoption of Rule 10C-1 under the Exchange Act of 1934, and represent another step toward implementing Section 952 of the Dodd-Frank Wall Street Reform and Accountability Act of 2010 (“Dodd-Frank”) and its directive that the exchanges adopt listing standards that, among other things, require compensation committees to:

- (i) be comprised solely of independent directors;
- (ii) have the authority to retain compensation advisers; and
- (iii) consider six independence factors in selecting not only compensation consultants but also any other advisers, including outside legal counsel.<sup>2</sup>

On both the NYSE and NASDAQ, the rules relating to a listed company’s authority to retain compensation advisers and consideration of such advisers’ independence will become effective on July 1, 2013. The rule changes relating to (i) heightened independence standards for compensation committee members and outside legal counsel on both the NYSE and NASDAQ and (ii) the requirement that NASDAQ listed companies have a standing compensation committee will become effective on the earlier of the first annual meeting after January 15, 2014 or October 31, 2014. NASDAQ listed companies face an additional compliance burden in that they must provide NASDAQ with a certification of compliance with the foregoing within 30 days after the applicable effective dates.

## ***Principal Changes from 2012 Proposed Rules***

The final NASDAQ and NYSE listing standards for compensation committees closely follow the proposals that the exchanges filed with the SEC in October 2012. However, both exchanges added an exception to the independence assessment requirements for compensation advisers, which provides that compensation committees are not required to conduct an independence assessment for a compensation adviser that acts in a role limited to the following activities for which no disclosure is required under Item 407(e)(3)(iii) of Regulation S-K: (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 company, and that is available generally to all salaried employees (e.g., an Employee Stock Purchase Program (ESPP) under IRC § 423); and/or (ii) 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 (e.g., some compensation survey data). The independence assessment requirement applies to any non in-house legal counsel to a compensation committee.

## ***Highlights of the Final Rules***

	<b>NYSE</b>	<b>NASDAQ</b>
<i>Heightened Independence Standards for Compensation Committee Members</i>	Boards will have to consider a director's compensation sources and affiliations	General prohibition on compensatory fees (subject to exceptions) and board must consider director's affiliations
<p>Note that neither exchange automatically disqualifies a director who is a significant stockholder, or appointed by one, from being independent. Those are merely factors to be considered.</p>		
<i>Requirement for Standing Compensation Committee</i>	No change to current NYSE rules requiring a standing compensation committee	Board must have a standing compensation committee
<i>Authority to Retain Compensation Advisers and Consideration of Independence of Such Advisers</i>	Committee must consider whether the compensation adviser has any material relationships relevant to independence from management	Committee must adopt formal charter specifying its responsibilities and authority to retain and fund compensation advisers and consideration of certain independence factors
<p>Note that both exchanges have reiterated the same six factors that the SEC articulated for independence assessments and the independence assessment is subject to the exception discussed above.</p>		
<i>Outside Legal Counsel</i>	The Compensation Committee must apply the six-factor test to anyone who provides outside legal counsel	No six-factor independence test unless the Compensation Committee is retaining its own outside counsel
<i>Smaller Reporting Companies</i>	The rules regarding compensation committee members and compensation	The rules regarding compensatory fees, affiliations and charter provisions specifying the authority

	<b>NYSE</b>	<b>NASDAQ</b>
	adviser independence would not apply, but the compensation adviser funding rule would	to retain and fund compensation advisers would not be applicable
<i>Controlled Companies and Foreign Private Issuers</i>	These rules would not be applicable	These rules would not be applicable

## **Background**

Prior to the enactment of Dodd Frank, the SEC already required companies to comprehensively disclose all material features of executive compensation under Item 402 of Regulation S-K, including disclosure of the interaction of executives and the board with respect to determining executive compensation, the use of benchmarking practices, peer groups, and compensation consultants. With the passage of Dodd-Frank, Congress mandated, among other things, that companies hold non-binding shareholder votes to approve executive compensation and golden parachute payments<sup>3</sup> and disclose the role and potential conflicts of compensation consultants.<sup>4</sup> The final listing rule changes reflect the latest development in an on-going campaign from all sides – Congress, the SEC, listing agencies, proxy advisers, and shareholders – to hold corporate boards more accountable for their compensation-related procedures and decisions.

## **NYSE FINAL LISTING RULE CHANGES RELATING TO COMPENSATION COMMITTEES**

The following is a general summary of the final changes to NYSE listing rules related to compensation committees.

### ***Independence Standards***

The final rule changes are set forth under Section 303A.02(a) of the NYSE Listed Company Manual, and require that boards of directors affirmatively assess the independence of compensation committee members. This involves applying the five “bright line” tests currently set forth in Section 303A.02(b) of the NYSE Listed Company Manual that each independent director must satisfy, and considering “all factors specifically relevant to determining whether the director has a relationship to the listed company which is material to his or her ability to be independent from management,” including:

- the source of the director’s compensation, including whether any of it derives from a source that would impair the director’s ability to make independent judgments regarding executive compensation; and
- any affiliate relationships between the director and the company or any of its subsidiaries, including whether the relationship places the director under the direct or indirect control of the listed company or its senior management.

### ***Compensation Advisers***

The final rule changes under Section 303A.05 of the NYSE Listed Company Manual replace existing NYSE rules regarding compensation committee advisers with guidelines specifically tracking the requirements of Rule 10C-1, and provide that:

- the compensation committee may, in its sole discretion, retain or obtain advice of a compensation consultant, independent legal counsel or other adviser;

- the compensation committee will be directly responsible for the appointment, compensation, and oversight of the work of any such adviser;
- the company must provide appropriate funding, as determined by the compensation committee, for payment of reasonable compensation to any such adviser; and
- in selecting *any* adviser, the compensation committee must take into consideration all factors relevant to that person's independence from management, including:
  1. the provision of other services to the company;
  2. the amount of fees received from the company by the person that employs the adviser, as a percentage of that person's total revenue;
  3. the policies and procedures of the person employing the adviser that are designed to prevent conflicts of interest;
  4. any business or personal relationship of the adviser with a compensation committee member;
  5. any stock of the company 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 company.

The final listing rules clarify that the compensation committee is not required to follow the advice of any such adviser. As described in more detail above under "Principal Changes from 2012 Proposed Rules," the independence assessment is not required for compensation advisers that, among other things, consult on broad-based plans or provide information that is not customized for a particular issuer. The independence assessment requirement applies to any legal counsel to a compensation committee, other than in-house counsel. Companies must include these provisions regarding compensation committee advisers in their compensation committee charters.

## **NASDAQ FINAL LISTING RULE CHANGES RELATING TO COMPENSATION COMMITTEES**

The following is a general summary of the final changes to NASDAQ listing rules related to compensation committees.

### ***Requirement to have a Compensation Committee with a Minimum of Two Directors***

Final Rule 5605(d)(2)(A) requires companies to have and certify that they have and will continue to have a standing compensation committee comprised of at least two members of the board of directors responsible for determining, or making a recommendation to the board of directors for determination, the compensation of the CEO and all other executive officers. This requirement modifies the current rule by imposing a minimum requirement as to the size of the committee and eliminating the provision permitting executive compensation to be determined by independent directors constituting a majority of the board's independent directors. When first proposing these changes, NASDAQ indicated its belief that it is appropriate to have a standing committee of at least two directors making compensation decisions, in light of the importance of such decisions to a company's stockholders, and so that

directors on a standing compensation committee may develop expertise in the company's executive compensation policies and programs.

***Independence – Limitations on Compensatory Fees and Consideration of Affiliations***

NASDAQ will continue to require that a compensation committee be comprised of "independent directors" as such term is currently defined in Rule 5602(a)(2), which sets forth certain relationships that will automatically preclude a finding of independence and requires that the board make an affirmative determination that the director does not have a relationship that (in the board's opinion) would interfere with the director's exercise of independent judgment in carrying out his or her responsibilities. Companies will continue to be permitted, under proposed Rule 5605(d)(2)(B), to appoint a non-independent director to serve on the compensation committee if the committee is comprised of at least three members and, the board, under exceptional and limited circumstances, determines that such individual's membership on the committee is required by the best interests of the company and its stockholders.

In addition to compliance with existing independence standards, final Rule 5605(d)(2) provides that:

- members of the compensation committee may not accept, directly or indirectly, any consulting, advisory or other compensatory fee from the company or any of its subsidiaries (regardless of any thresholds otherwise set forth under Rule 5602(a)(2); provided, however, that committee members are permitted to accept compensatory fees for board and board committee service and fixed amounts received as compensation under a retirement plan for prior service with the company); and
- the board, in determining eligibility to serve on the compensation committee, must consider whether the director has any affiliations with the company, any of its subsidiaries, or any affiliate of the company's subsidiaries that would impair the director's judgment as a member of the committee.

NASDAQ also amended IM-5605-6 (Independent Director Oversight of Executive Compensation) to clarify that affiliate evaluations may be based on particular facts and circumstances and that ownership of company stock or possession of a controlling interest through ownership of stock, in each case by itself, would not preclude a finding of independence. In fact, in proposing this amendment NASDAQ stated that 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."

The final listing rules relating to compensatory fees and affiliations do not have a "look-back" period and will begin with the committee member's term of service. Additionally, such rules would not apply to smaller reporting companies.

***Written Charter Setting Forth Responsibilities and Authority to Retain Advisers***

Final Rule 5605(d)(1) requires each listed company to certify that it has adopted a formal written compensation committee charter and that the committee will, annually, review and reassess the adequacy of such charter.<sup>5</sup>

In addition, the final rules require that a company's compensation committee charter (or board resolution, for smaller reporting companies) specify:

- the scope of the committee’s responsibilities and how it carries out those responsibilities, including structure, processes and membership requirements;
- the committee’s responsibility for determining, or recommending to the board for determination, the compensation of the CEO and all other executive officers of the company;
- that the CEO may not be present during voting or deliberations by the committee on his or her compensation; and
- the specific committee responsibilities and authority set forth in final Listing Rule 5605(d)(3), which implements certain requirements of Rule 10C-1 under the Exchange Act<sup>6</sup> (as set forth above for the NYSE under “Compensation Committee Advisers”) relating to the (i) authority to retain compensation consultants and advisers; (ii) authority to fund such advisers; and (iii) responsibility to consider certain independence factors before selecting such advisers, subject to the same exception discussed above; provided, however, that the requirements of clauses (i), (ii), and (iii) of this paragraph will not apply to smaller reporting companies.

## EFFECTIVE DATES<sup>7</sup>

### NYSE Rules

NYSE rule changes (other than heightened independence standards and compensation committee adviser rules)

### Effective Date

July 1, 2013

NYSE rule changes regarding heightened independence standards and compensation committee adviser rules

Earlier of a listed company’s first annual meeting after January 15, 2014, or October 31, 2014

### NASDAQ Rules

Rule 5605(d)(3) – Regarding changes to compensation committee responsibilities and authority

### Effective Date

July 1, 2013

All other changes to Rule 5605(d) and IM-5605-6 – Regarding compensation committee charter, composition, independence, compensatory fees and affiliations

Earlier of a listed company’s (i) first annual meeting after January 15, 2014, or (ii) October 31, 2014

Certification of compliance with amended listing rules

No later than 30 days after the deadline to implement the rules

## CURE PERIODS AND EXEMPTIONS

NYSE and NASDAQ listed companies may cure compensation committee composition defects, subject to certain applicable exceptions and conditions, by the earlier of: (i) the next annual meeting of shareholders; or (ii) the one-year anniversary of the event that caused non-compliance.<sup>8</sup> However, for NASDAQ listed companies if the annual shareholders meeting occurs within 180 days following the event that caused the noncompliance, the company instead has 180 days from the event to regain compliance, and NYSE limits the cure period’s use to circumstances where the committee continues to have a majority of independent directors.

As permitted by Rule 10C-1, the NYSE and NASDAQ will continue their current exemptions for, among others as specified in the applicable exchange rules, limited partnerships, management investment

companies registered under the Investment Company Act of 1940, controlled companies, certain passive issuers, and foreign private issuers.

## CONCLUSION

Companies can no longer wait to ensure that executive compensation and control of compensation-related activities are compliant with applicable standards. Over the past few years, the risks of derivative litigation have grown significantly, especially when shareholders perceive poor practices, pay-for-performance disconnects, or favorable litigation outcomes (most recently involving challenges to director compensation). To ensure such compliance and minimize personal liability risks for directors, companies should keep themselves actively apprised of new developments, not to mention being compliant with regulation at all levels: Congressional action, SEC regulation, and, as seen here, amendments to the exchange listing standards.

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*If you have any questions concerning these developing issues, please do not hesitate to contact any of the following Paul Hastings lawyers:*

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- <sup>1</sup> The final NYSE rule changes are available at <http://www.sec.gov/rules/sro/nyse/2013/34-68639.pdf>. The final NASDAQ rule changes are available at <http://www.sec.gov/rules/sro/nasdaq/2013/34-68640.pdf>.
  - <sup>2</sup> See, Mark Poerio and Elizabeth A. Razzano, [SEC Finalizes Rules for Compensation Committee Listing Standards and Compensation Consultant Conflicts](#), a Stay Current Client Alert from Paul Hastings, June 2012.
  - <sup>3</sup> See, Stephen Harris and Mark Poerio, [The SEC Issues Proposed Rules on Dodd-Frank's Executive Compensation Shareholder Approval Rules](#), a Stay Current Client Alert from Paul Hastings, October 2010.
  - <sup>4</sup> See, footnote 1 above.
  - <sup>5</sup> Note, concurrently with this change NASDAQ has also changed the corresponding audit committee requirement under Rule 5605(c) to provide that the audit committee "will review and reassess" the adequacy of its charter on an annual basis, instead of the currently retrospective requirement that the audit committee "has reviewed and reassessed" its charter on an annual basis.
  - <sup>6</sup> See, Mark Poerio and Elizabeth A. Razzano, [SEC Finalizes Rules for Compensation Committee Listing Standards and Compensation Consultant Conflicts](#), a Stay Current Client Alert from Paul Hastings, June 2012, for a discussion of the requirements of Rule 10-C-1(b)(2)–(4) under the Exchange Act, including the six independence factors set forth therein.
  - <sup>7</sup> See, Section 303A.00 of the NYSE Listed Company Manual and NASDAQ Listing Rule 5605(d)(6).
  - <sup>8</sup> See, NYSE Section 303A.00 and NASDAQ Listing Rule 5605(d)(4).