

February 5, 2013

SEC Approves Final NYSE and NASDAQ Compensation Committee Rules

Companies are required to comply with certain of the new listing standards relating to compensation adviser independence by July 1, 2013.

On January 11, 2013, the Securities and Exchange Commission (SEC) approved proposed amendments to the corporate governance listing standards of the New York Stock Exchange (NYSE) and the NASDAQ Stock Market (NASDAQ) relating to compensation committee and adviser independence requirements. In September 2012, NYSE and NASDAQ proposed these new listing standards (Original Proposals),¹ as directed by the SEC's final rules implementing Section 952 of the Dodd-Frank Wall Street Reform and Consumer Protection Act.² Subsequently, NYSE and NASDAQ submitted several amendments to the SEC, modifying the Original Proposals. The final NYSE and NASDAQ listing standards, as approved by the SEC, are substantially identical to the Original Proposals, as modified by these amendments.

The following summarizes key elements of the final listing standards and significant changes to the Original Proposals reflected in subsequent amendments submitted by NYSE and NASDAQ.

Key Elements of NYSE's Final Listing Standards

Compensation Committee Independence Requirements

Under NYSE's final listing standards, the board of directors must evaluate the independence of compensation committee members by considering factors "specifically relevant" to determining whether the director has a relationship with the company that is material to that director's ability to be independent from management, including the following two specified factors enumerated in Section 10C-1 of the Securities and Exchange Act of 1934, as amended (Exchange Act):

- Any compensation received by the director from any person or entity (including any consulting, advisory, or other compensatory fee paid by the company to such director)
- The director's affiliate relationship with the company, its subsidiary, or an affiliate of a subsidiary of the company

Additional NYSE guidance provides that the board should examine whether the receipt of such compensation would impair the director's ability to make independent judgments about the company's executive compensation. In addition, the board should consider whether the director's relationship with the company places such director under the direct or indirect control of the company or its senior management or creates a direct relationship with members of senior management, in each case of a nature that would impair his or her ability to make independent judgments about the company's executive compensation.

1. For more information on NYSE's and NASDAQ's proposed rules, see our October 31, 2012, LawFlash, "NYSE and NASDAQ Proposed Compensation Committee and Advisers Independence Rules," available at http://www.morganlewis.com/pubs/Securities_LF_CompensationCommitteeAndAdvisersIndependenceRules_31oct12.

2. For more information on the SEC's final rules, see our July 18, 2012, LawFlash, "SEC Adopts Compensation Committee and Adviser Independence Rules," available at http://www.morganlewis.com/pubs/Securities_LF_SECAadoptsRulesRelatingToListingStandards_18july12.

Compensation Adviser Requirements

NYSE's final listing standards require the compensation committee to (a) have the sole power to retain or obtain the advice of compensation consultants, legal counsel, and other advisers (collectively, Compensation Advisers) and (b) be responsible for the appointment, compensation, and oversight of such Compensation Advisers. Companies must also provide appropriate funding for reasonable compensation to Compensation Advisers retained by the compensation committee.

Prior to selecting or receiving advice from a Compensation Adviser (other than in-house legal counsel), the compensation committee must assess the independence of such Compensation Adviser by considering *all* relevant factors, including the six factors enumerated in Section 10C-1.³

Key Changes to NYSE's Original Proposal

NYSE's final listing standards incorporate several changes to the Original Proposal relating to the Compensation Adviser requirements. In the Original Proposal, companies would have been required to assess the independence of compensation consultants, "independent" legal counsel, and other advisers (other than in-house counsel). However, Rule 10C does not include the word "independent" before "legal counsel." To avoid confusion, NYSE's final listing standards, as amended, clarify that companies are required to assess the independence of "all" legal counsel to the compensation committee, not just "independent" legal counsel. NYSE's final listing standards provide, however, that Compensation Advisers do not have to be independent; the compensation committee simply must assess the Compensation Adviser's independence prior to selecting the Compensation Adviser.

Another key change to the Original Proposal was to clarify that, in addition to in-house counsel, a Compensation Adviser is not subject to the independence assessment requirements if its roles are limited to the following:

- 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.
- 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 for which the compensation consultant does not provide advice.

This exception is consistent with the exception for Compensation Advisers that conduct these activities from the disclosure requirement under Item 407(e)(3)(iii) of Regulation S-K.

Exemption for Foreign Private Issuers and Certain Other Entities

Foreign private issuers may follow home country practices related to compensation committees and advisers rather than comply with NYSE's final compensation committee-related listing standards. Consistent with the approach for many other NYSE corporate governance listing standards, a foreign private issuer must disclose in its annual report filed with the SEC any significant ways in which its home country rules relating to compensation committees and advisers differ from NYSE's listing standards applicable to domestic companies.

NYSE has also exempted from its final compensation committee-related listing standards limited partnerships, companies in bankruptcy proceedings, open-end management investment companies, controlled companies, asset-backed issuers and other passive issuers, and issuers whose only listed equity stock is a preferred stock, consistent with its historical approach to the oversight of executive compensation for those entities.

3. These six factors are (i) whether the employer of the Compensation Adviser, that is, the firm that employs the individual Compensation Adviser who will provide the compensation advice, is providing any other services to the issuer; (ii) the amount of fees received from the issuer by the employer of the Compensation Adviser as a percentage of the employer's total revenue; (iii) policies and procedures that have been adopted by the employer of the Compensation Adviser to prevent conflicts of interest; (iv) any business or personal relationship of the Compensation Adviser with a member of the compensation committee; (v) any stock of the issuer owned by the Compensation Adviser; and (vi) any business or personal relationship of the Compensation Adviser or employer of the Compensation Adviser with an executive officer of the issuer.

NYSE's final listing standards exempt smaller reporting companies from the heightened independence standards of compensation committee members and the requirement to assess Compensation Adviser independence. Accordingly, the compensation committee charters of smaller reporting companies need not specify the need for the assessment of the independence of Compensation Advisers. However, smaller reporting companies will be subject to the standards relating to the authority, responsibility, and funding of Compensation Advisers.

Implementation Timeline

NYSE-listed companies must comply with the final listing standards relating to the authorities, funding, and responsibilities of the compensation committee—including the requirements to assess the independence of Compensation Advisers and adopt a compliant committee charter—by July 1, 2013. NYSE companies must comply with the heightened independence standards of compensation committee members by the earlier of (a) the first annual meeting after January 15, 2014 or (b) October 31, 2014.

Key Elements of NASDAQ's Final Listing Standards

Compensation Committee Structure and Charter Requirements

NASDAQ's final listing standards require listed companies to establish a standing compensation committee consisting of at least two independent directors. NASDAQ-listed companies must also adopt a formal written compensation committee charter addressing certain matters, including the scope of the committee's responsibilities, how it carries out its responsibilities, and specific responsibilities relating to the retention and compensation of Compensation Advisers and the assessment of their independence.

Compensation Committee Independence

NASDAQ's final listing standards include two additional requirements with respect to the independence of compensation committee members. First, NASDAQ prohibits a compensation committee member from accepting, directly or indirectly, any consulting, advisory, or other compensatory fee from the company or its subsidiaries (other than directors' fees). This mandatory prohibition is modeled after the independence standard set forth in Section 10A(m)(3) of the Exchange Act for audit committee membership under the Sarbanes-Oxley Act of 2002, as amended. Second, NASDAQ requires the board to consider the affiliate status of the director and whether such affiliation would impair the director's judgment as a member of the compensation committee. This second requirement does not impose a bar based on the compensation committee member's affiliation with the company.

Compensation Adviser Requirements

Under NASDAQ's final listing standards, the compensation committee must have the authority to retain or obtain the advice of a Compensation Adviser and must be directly responsible for the appointment, compensation, and oversight of Compensation Advisers. NASDAQ-listed companies must also provide appropriate funding for reasonable compensation to Compensation Advisers retained by the compensation committee.

NASDAQ's final listing standards require that, prior to selecting or receiving advice from a Compensation Adviser, the compensation committee must assess the independence of the Compensation Adviser by considering the six factors enumerated in Section 10C-1. This is different from NYSE's standards, which contain a "catch all" provision requiring the consideration of "all" relevant factors including the six enumerated factors.

Key Changes to NASDAQ's Original Proposal

NASDAQ's final listing standards incorporate several amendments to NASDAQ's Original Proposal that relate to the Compensation Adviser independence requirements. Similar to NYSE's amendments, NASDAQ amended its Original Proposal to clarify that the Compensation Adviser independence assessment requirements apply to "all" Compensation Advisers (other than in-house counsel), not just "independent" advisers. NASDAQ also clarified that, rather than requiring the Compensation Adviser to be independent, the final listing standards only require the compensation committee to assess the Compensation Adviser's independence prior to selecting the Compensation Adviser. In addition, similar to NYSE's amendment discussed above, NASDAQ amended its Original Proposal to include the same exception from the Compensation Adviser independence assessment

requirements as the exception that NYSE's listing standards have for any Compensation Adviser whose roles are limited to the activities described in Item 407(e)(3)(iii) of Regulation S-K.

Exemption for Foreign Private Issuers and Certain Other Entities

Foreign private issuers may follow home country practices related to compensation committees and advisers rather than comply with NASDAQ's final compensation committee-related listing standards, provided that they describe in their annual reports filed with the SEC the home country practices with which they comply. In a departure from its approach for other NASDAQ corporate governance listing standards, however, a foreign private issuer must also disclose in its annual report (or on its website if it is not required to file an annual report with the SEC) the reasons why it does not have an independent compensation committee complying with NASDAQ's standards.

NASDAQ has also exempted from its final compensation committee-related listing standards limited partnerships, cooperatives, open-end and closed-end management investment companies, controlled companies, and asset-backed issuers and other passive issuers, consistent with its historical approach to the oversight of executive compensation for those entities.

NASDAQ's final listing standards exempt smaller reporting companies from all of the new compensation committee-related requirements, consistent with the provisions of Rule 10C-1. The new standards provide, however, that a smaller reporting company must have, and certify that it has and will continue to have, a compensation committee of at least two members who must be independent without regard to the two new independence criteria relating to receipt of fees and affiliations. In addition, a smaller reporting company must have a compensation committee charter or its board must adopt a board resolution that specifies the committee's responsibilities set forth in Rule 5605(d)(10)(A) to (C), which do not include the new responsibilities and authority relating to Compensation Advisers.

Implementation Timeline

NASDAQ revised the timing of compliance in its Original Proposal to be consistent with the effective dates of NYSE's standards. NASDAQ-listed companies must now comply with the final listing standards relating to the authorities, funding, and responsibilities of the compensation committee—including the requirement to assess the independence of Compensation Advisers—by July 1, 2013. NASDAQ-listed companies must comply with the remaining provisions—including the establishment of a separate compensation committee, the heightened independence standards of compensation committee members, and the written charter requirements—by the earlier of (a) the first annual meeting after January 15, 2014 or (b) October 31, 2014. NASDAQ-listed companies must also certify compliance with the final listing standards within 30 days after the applicable deadlines.

Practical Considerations

Review and assessment of compensation committee composition: Companies and boards should analyze the independence of existing or potential members of their compensation committee based on the new listing standards as soon as possible so they can begin to identify directors or nominees for directors who would meet the enhanced conditions. The board and the compensation committee should be informed and educated so they can be prepared to undertake the necessary steps to comply with the rules. Any NASDAQ-listed company that currently does not have a standing compensation committee should begin the process of forming such a committee.

Review of and amendments to compensation committee charters and D&O questionnaires: Companies should update their committee charters, directors' and officers' (D&O) questionnaires, and corporate governance guidelines or policies to reflect the new rules, which should include additional questions designed to assist in the analysis of the heightened independence standards of compensation committee members. In particular, a NASDAQ-listed company will need to adopt a compensation committee charter if it doesn't already have one and, even if it has one, will likely need to include several additional provisions in the charter to comply with the new requirements.

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Analysis of Compensation Adviser independence: Companies and compensation committees should establish or update procedures for collecting the information necessary to conduct the required independence analysis relating to Compensation Advisers, including any outside legal counsel who provides advice to the compensation committee. These procedures may include the completion of screening questionnaires for Compensation Advisers, additional interview sessions, and committee meetings to discuss independence. Since the SEC rules now require the disclosure about any conflict of interest of compensation consultants in annual proxy statements, companies should ensure that their disclosure and control procedures are designed to comply with these requirements.

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