

# NYSE and Nasdaq Propose Listing Standards on Compensation Committees and Advisers

October 2, 2012

On September 25, 2012, both the **NYSE** and **Nasdaq** proposed listing standards to implement the SEC's **requirement** that national securities exchanges prohibit the listing of any equity security of an issuer that does not comply with the SEC's rules regarding the independence of compensation committees<sup>1</sup> and their advisers.

The NYSE made few changes from the SEC's final rules<sup>2</sup>, which in turn hewed very closely to the requirements of Section 952 of the Dodd-Frank Act. While the Nasdaq also largely followed the SEC's final rules, its proposed standards added a few requirements, including a bright-line prohibition against the receipt by a compensation committee member of any consulting, advisory or other compensatory fees (with limited exceptions). The proposed effective dates are also different.

In 2003, although the two exchanges initially proposed different listing standards regarding the independence of directors generally, the final rules as approved by the SEC were substantially aligned. It remains to be seen whether these listing standards will also become more similar.

Appendix A contains a side-by-side comparison of the proposed NYSE and Nasdaq listing standards.

## NYSE Proposed Listing Standards

### Effectiveness

Listed companies will have until their first annual meeting after January 15, 2014, or, if earlier, October 31, 2014, to comply with the compensation committee member independence standards. Other standards, including the compensation committee adviser requirements and compensation committee charter requirements, become effective on July 1, 2013.<sup>3</sup>

### Compensation Committee Member Independence

Under its proposed listing standards, the NYSE adopted the same factors to be considered in evaluating the independence of a compensation committee member as provided in the final SEC rules:

- the source of compensation of the director, including any consulting, advisory or other compensatory fees paid by the listed company; and
- whether the director has an affiliate relationship with the listed company, a subsidiary of the listed company or an affiliate of a subsidiary of the listed company.

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<sup>1</sup> This memorandum discusses the independence requirements applicable to compensation committee members under the proposed NYSE and Nasdaq listing standards. Many listed companies also consider analogous, but different, requirements for their compensation committee members so that they qualify as "outside directors" under Section 162(m) of the Internal Revenue Code, "non-employee directors" under Section 16 of the Securities Exchange Act of 1934 and independent directors for purposes of ISS and Glass Lewis voting guidelines.

<sup>2</sup> For a discussion on the SEC's final rules, please see [here](#).

<sup>3</sup> On October 1, 2012, the NYSE published an updated [rule filing](#) to correct an error relating to the effectiveness of the proposed listing standards.

The NYSE does not prescribe any bright-line tests based on the factors above, but instead leaves to the board the ultimate determination as to whether any aspect of these factors affects the independence of a compensation committee member. The NYSE explained that its existing bright-line independence standards for directors generally are sufficiently broad to encompass the types of relationships that would generally be material and, therefore, the new factors above remain considerations rather than bright-line standards. The commentary to the NYSE proposed listing standards states that, in making an independence assessment for a compensation committee member, the board must consider whether the director receives compensation from any person or entity that would impair independence or whether an affiliate relationship places the director under control of the company or management, or creates a relationship between the director and management, in each case in a way that would impair the director's ability to make an independent judgment about the company's executive compensation.

The NYSE proposal provides a cure period for any independent compensation committee member who ceases to be independent for reasons outside of his or her control, so long as a majority of the members of the compensation committee continue to be independent. This cure period lasts until the listed company's next annual meeting, or, if earlier, one year from the event that caused the compensation committee member to no longer be independent.

## Advisers to Compensation Committees

The NYSE proposed listing standards regarding compensation committee advisers follow the SEC's final rules. These provisions of the proposed listing standards will replace the NYSE's existing standards (which are found in Section 303A.05(b)(i)) when the proposed standards become effective.

A compensation committee may, in its sole discretion, retain or obtain the advice of compensation consultants and other advisers, only after taking into consideration specified independence factors, and listed companies must provide funding for the retention of these advisers. Compensation committees will be directly responsible for the selection, compensation and oversight of the advisers they retain.

Before selecting a compensation consultant or other adviser, the compensation committee must take into consideration *all* factors relevant to that adviser's independence from management, including the following six factors (the "**Six Specified Factors**"):

- the provision of other services to the listed company by the adviser's employer;
- the amount of fees received from the listed company by the adviser's employer, 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 listed 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 listed company.

The NYSE declined to propose any additional considerations or bright-line thresholds with respect to the above factors. The independence assessment applies to any compensation consultant or other adviser that provides advice to the compensation committee, other than in-house counsel. Although compensation committees are required to consider these factors in selecting their advisers, there is no requirement that the advisers actually be independent and there is no required disclosure of the considerations that were taken into account for advisers.

Consistent with the SEC's final rules, the NYSE proposed listing standards provide that the compensation committee is not required to implement the advice of its advisers and that nothing affects the ability of the compensation committee to exercise its own judgment in fulfilling its duties.

Neither the NYSE nor the Nasdaq proposal addresses some of the thornier interpretative questions, such as whether compensation committees would need to perform an independence assessment of any adviser that advises management but does not itself come before the compensation committee or the scope of the independence assessment for advisers that are entities.

## **Application of Rules to Certain Types of Companies**

### **General Exemption and Controlled Companies**

Pursuant to the general exemptive authority provided in the SEC's final rules, the NYSE's proposed listing standards exempt from the compensation committee independence and compensation committee adviser requirements all issuers that are currently exempt from the NYSE compensation committee requirements. This includes controlled companies (i.e., companies where a single investor or group of investors hold more than 50% of the voting power for the election of directors), limited partnerships, companies in bankruptcy, closed-end and open-end funds registered under the Investment Company Act of 1940, passive business organizations in the form of trusts, derivatives and special purpose securities, and issuers whose only listed equity security is preferred stock.

### **Foreign Private Issuers**

Foreign private issuers that follow their home country practice will be exempt from the compensation committee independence and compensation committee adviser requirements. Existing Section 303A.11 of the NYSE listing standards requires foreign private issuers to disclose any significant ways in which their corporate governance practices differ from those followed by domestic companies under NYSE listing standards. A foreign private issuer that is required to file an annual report on Form 20-F with the SEC must include a statement of significant differences in that annual report. A foreign private issuer that is not required to file an annual report on Form 20-F can include this statement in an annual report filed with the SEC or on the listed company's website. For example, the commentary to the proposal notes that it would be sufficient for a foreign private issuer to simply state that its home country laws do not require an independent compensation committee, if that is the case.

If a foreign private issuer ceases to qualify as a foreign private issuer, it will have a six-month transition period before it is required to have a fully independent compensation committee.

### **Companies Listing In Connection with Their Initial Public Offering**

Newly listed public companies will be subject to the proposed listing standards. However, the existing transition period available for companies that list in connection with an IPO will continue to apply. Thus, although such a company would be required to have at least one independent member on its compensation committee by the earlier of the date the IPO closes or five business days following the listing date, it would have 90 days from the listing date for at least a majority of its compensation committee to be independent and one year from the listing date for the full committee to be independent.

### **Smaller Reporting Companies**

Smaller reporting companies are exempt from the compensation committee independence requirements and the compensation committee adviser independence requirements. Smaller reporting companies will be subject to the proposed listing standards relating to the ability of compensation committees to retain or obtain the advice of compensation consultants and have funding provided by the listed company, but will not be required to take into account the new independence factors when selecting an adviser.

## Nasdaq Proposed Listing Standards

### Effectiveness

As proposed, the Nasdaq's listing standards relating to the compensation committee responsibilities and authority and compensation committee adviser independence will become immediately effective on the day they are adopted. The Nasdaq proposal includes additional changes, such as compensation committee member independence standards, which would apply to a listed company's compensation committee as of the company's second annual meeting after the changes are adopted, or, if earlier, December 31, 2014.

Each listed company must certify to the exchange within 30 days after the implementation deadline above, in a form to be provided by the Nasdaq, that it has complied with the amended listing standards on compensation committees.

### Compensation Committee Membership, Independence and Charter

The current Nasdaq listing standards permit for a majority of the board's independent directors to make compensation decisions with respect to executive officers. However, as a practical matter, the vast majority of Nasdaq companies have a compensation committee. The proposed listing standards would now require listed companies to have a compensation committee consisting of at least two independent members and a written formal compensation committee charter.<sup>4</sup>

The independence of a director for service on the compensation committee will be judged under two new factors included in the proposed Nasdaq standards, consistent with the final SEC rules:

- the source of compensation of the director, including any consulting, advisory or other compensatory fees paid by the listed company; and
- whether the director has an affiliate relationship with the listed company, a subsidiary of the listed company or an affiliate of a subsidiary of the listed company.

The Nasdaq proposal requires that a listed company's board consider whether a director is affiliated with the company, a subsidiary of the company or an affiliate of a subsidiary of the company in assessing the director's independence for compensation committee service, but does not any provide for any bright-line prohibition with respect to affiliation. The Nasdaq's commentary notes that certain affiliations, such as a representative of a significant stockholder whose interests are likely aligned with those of other stockholders regarding executive compensation, may be appropriate for a compensation committee member and, therefore, a bright-line prohibition is not appropriate.

However, in perhaps the most marked difference from the approach of the SEC and NYSE, the Nasdaq proposed listing standards provide that a director's receipt of compensation from a listed company should not only be a factor to be considered in making an independence determination but should constitute a bright-line prohibition against the director's service on the compensation committee. In this respect, the Nasdaq proposal adopts the same standard that applies to audit committee members under Rule 10A-3. This would prohibit a compensation committee member of a Nasdaq listed company from accepting, directly or indirectly, any consulting, advisory or other compensatory fee from the listed company or any subsidiary. Similar to the standards for audit committees, indirect compensation would likely include amounts received by certain family members sharing a household and certain employees of the director.

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<sup>4</sup> The NYSE's existing Section 303A.05(a) requires that a listed company's compensation committee consist solely of independent directors; and the NYSE's existing Section 303A.05(b) requires a written compensation committee charter that covers certain prescribed items, including the committee's purpose and responsibilities and an annual performance evaluation of the committee.

However, the prohibition would not apply to board and committee fees and amounts received under a retirement plan for prior service with the listed company (provided that such compensation is not contingent on continued service) and there would be no look-back period with respect to compensation received by a director prior to his or her appointment.

Nasdaq retained an existing exception applicable to boards with compensation committees. Under this exception, if the compensation committee has at least three members, the board may appoint one director who is not independent if such director is not an executive officer or employee or a family member of an executive officer and the board determines that such appointment is required in the best interests of the listed company. Any compensation committee member who is not independent can only serve on the committee for up to two years. If a listed company relies on this exception, it must disclose its reliance either on its website or in its next proxy statement and must disclose the nature of the relationship and the reasons for the determination.

The Nasdaq proposal provides a cure period for independent compensation committee members who cease to be independent for reasons outside of such member's control. This cure period lasts until the first anniversary of the event that caused the compensation committee member to no longer be independent, or, if earlier, the listed company's next annual meeting. However, if the next annual meeting is less than 180 days from the event that caused the compensation committee member to no longer be independent, the listed company will have 180 days to cure such noncompliance. A similar cure period applies if a compensation committee fails to comply with the compensation committee membership requirement in the proposed listing standards due to one vacancy on the committee (*i.e.*, the committee will be deemed a valid independent committee until the first anniversary of the event that caused the noncompliance or, if earlier, the next annual meeting, but not less than 180 days from the date of such noncompliance event).

The proposed listing standards require the compensation committee to adopt a charter specifying:

- the scope of the committee's responsibilities and how it carries out those responsibilities;
- that the committee has the responsibility for determining, or recommending to the board, the compensation of the CEO and all other executive officers;
- that the CEO may not be present during voting or deliberations regarding his or her compensation; and
- that the committee has the authority to retain advisers and provide funding for such advisers and will consider independence factors before selecting any advisers, other than in-house legal counsel.

If a listed company does not yet have a compensation committee at the time of the listing standards' effectiveness, the responsibilities and authority relating to the ability to obtain advisers, provide funding for such advisers and the consideration of independence factors will apply to the independent directors who determine, or recommend to the board, the compensation for the executive officers of the listed company.

## Advisers to Compensation Committees

The Nasdaq proposed listing standards track the SEC final rules relating to compensation committee advisers. Before selecting a compensation consultant or other adviser, the compensation committee must take into consideration the same Six Specified Factors as previously noted under the NYSE proposed listing standards, namely:

- the provision of other services to the listed company by the adviser's employer;
- the amount of fees received from the listed company by the adviser's employer, 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 listed 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 listed company.

The Nasdaq declined to propose any additional considerations or bright-line thresholds with respect to these factors. The independence assessment applies to any compensation consultant or other adviser that provides advice to the compensation committee, other than in-house counsel. Although compensation committees are required to consider these independence factors in selecting their advisers, there is no requirement that the advisers actually be independent and there is no required disclosure of the considerations that were taken into account.

Consistent with the SEC's final rules, the Nasdaq proposed listing standards provide that the compensation committee is not required to implement the advice of its advisers and that nothing affects the ability of the compensation committee to exercise its own judgment in fulfilling its duties.

## **Application of Rules to Certain Types of Companies**

### **General Exemption and Controlled Companies**

Pursuant to the general exemptive authority provided in the SEC final rules, the Nasdaq proposed listing standards exempt all issuers from the compensation committee independence and compensation committee adviser requirements who are currently exempt from the Nasdaq compensation-related listing rules. This includes controlled companies, asset-backed issuers and other passive issuers, cooperatives, limited partnerships and management investment companies.

### **Foreign Private Issuers**

Foreign private issuers that follow their home country practice will be exempt from the compensation committee independence and compensation committee adviser requirements. In addition, the Nasdaq proposed listing standards also require foreign private issuers that follow their home country practice and do not have an independent compensation committee to disclose the reasons why they do not have such a committee in their annual report filed with the SEC. A foreign private issuer that is not required to file its annual report with the SEC on Form 20-F may make this disclosure only on its website.

### **Companies Listing In Connection with Their Initial Public Offering**

Newly listed public companies will be subject to the proposed listing standards. However, the existing transition period available for companies that list in connection with an IPO will continue to apply. Thus, although such a company would be required to have at least one independent member on its compensation committee by the listing date, it will have 90 days from the listing date for at least a majority of its compensation committee to be independent and one year from the listing date for the full committee to be independent.

### **Smaller Reporting Companies**

Smaller reporting companies are exempt from the compensation committee independence requirements and the compensation committee adviser independence requirements. Smaller reporting companies will be subject to the proposed listing standards relating to the ability of compensation committees to retain or obtain the advice of compensation consultants and have funding provided by the listed company. In addition, smaller reporting companies will be subject to the proposed listing standards relating to the establishment of a compensation committee. However, rather than adopting a written compensation committee charter, a smaller reporting company is permitted to include the charter elements in board

resolutions relating to the compensation committee's duties and authorities and is not required to review and reassess the charter, or board resolutions, as the case may be, on an annual basis.

## Comments

Both proposals will be published by the SEC, and comments are due on or before the date that is 21 days from publication in the Federal Register.

The SEC requires the NYSE and Nasdaq to have final rules no later than June 27, 2013.

## What To Do Now

In anticipation of the adoption of these new listing standards, listed companies should:

- review the proposed standards applicable to them and watch for the final approval by the SEC;
- review their charters and begin considering the addition of provisions reflecting the proposed listing standards;
- consider analyzing the membership of their compensation committees to ensure that no additional relationships need to be considered in making the independence determination, including whether any compensation committee member receives any prohibited compensatory fees or has any affiliate relationships; and
- consider how to incorporate the new independence factors and prepare to review their compensation committee advisers.

In addition, Nasdaq listed companies that do not have a compensation committee or charter should begin to think about how to put these in place.

While there is no requirement that compensation committee advisers be independent and no requirement to disclose information regarding all compensation committee advisers, remember that the disclosure changes with respect to compensation consultants and conflicts of interest in Item 407 of Regulation S-K will apply to proxy statements for annual meetings that occur on or after January 1, 2013. These changes require the consideration of factors, including the Six Specified Factors, in determining whether any conflict exists with respect to a compensation consultant determining or recommending the amount or form of executive or director compensation, and, if so, disclosure in the issuer's 2013 proxy statement regarding the nature of any conflict and how it is being addressed.

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If you have any questions regarding the matters covered in this publication, please contact any of the lawyers listed below or your regular Davis Polk contact.

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Appendix A

Item	NYSE	Nasdaq
<p><b>Application Dates</b></p>	<ul style="list-style-type: none"> <li>▪ Compliance with the compensation committee member independence standards, by the earlier of (i) the listed company's first annual meeting after January 15, 2014, or (ii) October 31, 2014.</li> <li>▪ Other standards, including those that relate to the compensation committee adviser requirements and compensation committee charter requirements, become effective on July 1, 2013.</li> </ul>	<ul style="list-style-type: none"> <li>▪ The proposed listing standards relating to the compensation committee authority and compensation committee adviser independence requirements will become effective immediately upon adoption of the proposed rules.</li> <li>▪ For all other listing standards, the earlier of (i) the listed company's second annual meeting after the proposed listing standards are adopted, or (ii) December 31, 2014.</li> <li>▪ Within 30 days of the implementation deadline above, listed companies must certify that they have complied with the amended listing standards on compensation committees.</li> </ul>
<p><b>Establishment of Compensation Committee</b></p>	<ul style="list-style-type: none"> <li>▪ Already required by the NYSE's listing standards.</li> </ul>	<ul style="list-style-type: none"> <li>▪ <b>Rule:</b> Compensation committee required. Must have at least two members.</li> <li>▪ <b>Cure:</b> If there is one vacancy on the committee, a cure period exists until the earlier of the next annual meeting and one year from the event that caused the noncompliance. However, the cure period will not be less than 180 days.</li> </ul>
<p><b>Compensation Committee Charter</b></p>	<ul style="list-style-type: none"> <li>▪ Already required by the NYSE's listing standards.</li> </ul>	<ul style="list-style-type: none"> <li>▪ <b>Rule:</b> Required to have a formal written compensation committee charter that specifies:               <ul style="list-style-type: none"> <li>▪ the scope of responsibility and how it is carried out;</li> <li>▪ responsibility for determining, or recommending to the board, the compensation of the CEO and all other executive officers;</li> <li>▪ that the CEO may not be present during voting or deliberations regarding his or her compensation; and</li> <li>▪ that the compensation committee has the authority to retain advisers, provide funding for such advisers and will consider independence factors before selecting any advisers.</li> </ul> </li> </ul>

		<ul style="list-style-type: none"> <li>▪ <b>Rule:</b> The compensation committee must review and reassess the charter each year.</li> </ul>
<b>Compensation Committee Authority</b>	<ul style="list-style-type: none"> <li>▪ Sole discretion to retain or obtain the advice of an adviser.</li> <li>▪ Listed companies must provide funding for the retention of advisers.</li> </ul>	<ul style="list-style-type: none"> <li>▪ Same as NYSE.</li> </ul>
<b>Compensation Committee Independence</b>	<ul style="list-style-type: none"> <li>▪ <b>Rule:</b> Factors to be taken into consideration (no bright-line test): <ul style="list-style-type: none"> <li>▪ the source of compensation of a member of the board of directors, including any consulting, advisory or other compensatory fees paid by the listed company; and</li> <li>▪ whether a member of the board of directors has an affiliate relationship with the listed company, a subsidiary of the listed company or an affiliate of a subsidiary of the listed company.</li> </ul> </li> <li>▪ <b>Cure:</b> If an independent compensation committee member ceases to be independent for reasons outside of his or her control, so long as a majority of the members of the compensation committee continue to be independent, such director will have a cure period for the earlier to occur of the listed company's next annual meeting or one year from the date of the noncompliance event.</li> </ul>	<ul style="list-style-type: none"> <li>▪ <b>Rule:</b> Factors: <ul style="list-style-type: none"> <li>▪ <b>Prohibition</b> – cannot accept, directly or indirectly, any consulting, advisory or other compensatory fee from the listed company or any subsidiary, other than fees for serving as a board member or amounts under a vested retirement plan; and</li> <li>▪ <b>Consideration</b> – whether a member of the board of directors has an affiliate relationship with the listed company, a subsidiary of the listed company or an affiliate of a subsidiary of the listed company.</li> </ul> </li> <li>▪ <b>Exception:</b> If there are at least three members on the compensation committee, the board may appoint one non-independent member if it is in the best interests of the listed company and the nature of the relationship and the reasons for the determination are publicly disclosed.</li> <li>▪ <b>Cure:</b> If an independent compensation committee member ceases to be independent for reasons outside of his or her control, such director will have a cure period for the earlier to occur of the listed company's next annual meeting or one year from the date of the noncompliance event. However, the cure period will not be less than 180 days.</li> </ul>
<b>Compensation Committee Advisers</b>	<ul style="list-style-type: none"> <li>▪ The compensation committee must consider all factors relevant to the adviser's independence from management, including the following six factors: <ul style="list-style-type: none"> <li>▪ the provision of other services to the listed company by the person that employs the adviser;</li> <li>▪ the amount of fees received from</li> </ul> </li> </ul>	<ul style="list-style-type: none"> <li>▪ The compensation committee must consider the following six factors: <ul style="list-style-type: none"> <li>▪ the provision of other services to the listed company by the person that employs the adviser;</li> <li>▪ the amount of fees received from the listed company by the person that employs the adviser, as a percentage of the total revenue of</li> </ul> </li> </ul>

	<p>the listed company by the person that employs the adviser, as a percentage of the total revenue of the person that employs the adviser;</p> <ul style="list-style-type: none"> <li>▪ the policies and procedures of the person that employs the adviser that are designed to prevent conflicts of interest;</li> <li>▪ any business or personal relationship of the adviser with a member of the compensation committee;</li> <li>▪ any stock of the listed company owned by the adviser; and</li> <li>▪ any business or personal relationship of the adviser or the person that employs the adviser with an executive officer of the issuer.</li> </ul>	<p>the person that employs the adviser;</p> <ul style="list-style-type: none"> <li>▪ the policies and procedures of the person that employs the adviser that are designed to prevent conflicts of interest;</li> <li>▪ any business or personal relationship of the adviser with a member of the compensation committee;</li> <li>▪ any stock of the listed company owned by the adviser; and</li> <li>▪ any business or personal relationship of the adviser or the person that employs the adviser with an executive officer of the issuer.</li> </ul>
<b>General Exemptions</b>	<ul style="list-style-type: none"> <li>▪ Exempt all listed companies, including controlled companies, that are currently exempt from the NYSE compensation committee requirements.</li> </ul>	<ul style="list-style-type: none"> <li>▪ Exempt all listed companies, including controlled companies, that are currently exempt from the Nasdaq compensation-related listing standards.</li> </ul>
<b>Foreign Private Issuers</b>	<ul style="list-style-type: none"> <li>▪ Exempt if the home country practice is followed.</li> <li>▪ Existing listing standards already require disclosure of any significant corporate governance practices.</li> </ul>	<ul style="list-style-type: none"> <li>▪ Exempt if the home country practice is followed and the listed company discloses with the SEC the reasons why it does not have an independent compensation committee.</li> </ul>
<b>Newly Registered Companies in Connection with an IPO</b>	<ul style="list-style-type: none"> <li>▪ No exemption.</li> <li>▪ The existing transition period available for companies that list in connection with an initial public offering will continue to apply.</li> </ul>	<ul style="list-style-type: none"> <li>▪ Same as NYSE.</li> </ul>
<b>Smaller Reporting Companies</b>	<ul style="list-style-type: none"> <li>▪ Exempt from the compensation committee independence requirements and the compensation committee adviser independence requirements.</li> <li>▪ Subject to the compensation committee authority provisions.</li> </ul>	<ul style="list-style-type: none"> <li>▪ Same as NYSE.</li> <li>▪ Subject to the requirement to establish a compensation committee.</li> <li>▪ Subject to the written compensation committee charter requirement, provided it can be in a board resolution and is not required to be reviewed annually.</li> </ul>

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