# SEC Approves the NYSE and Nasdaq Listing Standards on Compensation Committees and Advisers

January 22, 2013

On January 11, 2013, the SEC approved the **NYSE** and **Nasdaq** listing standards, as amended, 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 and their advisers.[1] In approving the proposed **NYSE** and **Nasdaq** listing standards, the SEC did not require any changes.[2]

This memo highlights the key aspects of the final listing standards. Appendix A provides further details regarding the final standards and their application to certain types of companies, such as foreign private issuers, recently IPOed companies and smaller reporting companies.

## Highlights of Final Listing Standards

- Nasdaq retained its bright-line prohibition on any compensatory payments (other than directors' fees) to compensation committee members.
- In evaluating compensation committee adviser independence, the NYSE requires consideration of *all* factors relevant to an adviser's independence, in addition to six enumerated factors. Nasdaq does not have a similar catch-all requirement.
- The compensation committee must review independence for *all* of its advisers, with limited exceptions for (1) in-house counsel and (2) certain advisers providing limited services (as more fully explained below).
- Non-independent advisers may still serve the committee (i.e., they are not prohibited); however, prior review of these advisers is required.
- The SEC expects review of adviser independence at least annually.

## The Independence Tests

Both the NYSE and Nasdaq listing standards require consideration of two factors (in addition to the existing general independence tests[3]) in determining compensation committee independence and six factors in determining the independence of advisers, if any.

---

[1] This memorandum discusses the independence requirements applicable to compensation committee members under the NYSE and Nasdaq listing standards. Many listed companies also consider analogous, but different, independence 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 (the "**Exchange Act**") and independent directors for purposes of ISS and Glass Lewis voting guidelines.

[2] For a discussion of the listing standards as initially proposed, please see **here**.

[3] In approving both the NYSE and Nasdaq listing standards, the SEC expressly noted that compliance with the exchanges' compensation committee member independence standards requires consideration of factors that include any personal and business relationships and related party transactions, because compensation committee members must meet the general independence requirements under existing listing standards in addition to the two new criteria.

### Compensation Committee Member Independence

The board of directors must evaluate the independence of any compensation committee member by considering:

- 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.

With respect to the first prong of this test, for Nasdaq-listed companies, a director who receives such compensatory payments (other than directors' fees) is prohibited from being an independent compensation committee member.

### Advisers to Compensation Committees

Before selecting or receiving advice from a compensation consultant or other adviser (whether with respect to executive compensation matters or otherwise), the compensation committee must take into consideration the following 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.

In addition, the NYSE requires consideration of *all* factors relevant to an adviser's independence. Nasdaq does not have a similar catch-all requirement.

## Highlights of Final NYSE Listing Standards

### Effective Dates

NYSE-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 need to evaluate compensation committee advisers and the compensation committee authority and charter requirements, become effective on July 1, 2013.

### Compensation Committee Member Independence

The final NYSE listing standards with respect to compensation committee member independence do not differ from the standards as initially proposed. The NYSE made a few clarifying statements in response to comments. In particular, in response to comments that suggested that directors' fees should be taken into consideration for independence purposes, the NYSE noted that it does not believe that it is likely that directors' fees would be relevant to an independence analysis. However, "excessive" director compensation may need to be evaluated as possibly impairing independence, as the listing standards require the consideration of all relevant factors. There was no indication of what might constitute excessive board compensation. In response to other comments, the NYSE specifically confirmed that a single factor or relationship considered in the independence analysis could be sufficiently material to render a director non-independent.

### Advisers to Compensation Committees

The NYSE amended its initial proposal to specifically exempt from the independence analysis advisers covered by the exception in Item 407(e)(3)(iii) of Regulation S-K, which excepts an adviser whose role is limited to (a) consulting on any broad-based plan that does not discriminate in scope, terms or operation, in favor of executive officers or directors, and that is available generally to all salaried employees or (b) providing information that either is not customized or that is customized based on parameters that are not developed by the adviser, and about which the adviser does not provide advice. This makes clear that advisers who merely provide general compensation surveys to compensation committees need not be subject to the required independence review.

In response to a comment, the NYSE clarified that the independence of any outside legal counsel, including the company's regular securities and tax counsel, must be evaluated prior to their being selected by or providing advice to the compensation committee. Only in-house counsel and compensation consultants that fall into the limited exception noted above are excluded from this evaluation. The NYSE specifically noted that it does not think the existence of indemnification agreements or contractual limitations on liability is relevant to an independence analysis.

## Highlights of Final Nasdaq Listing Standards

### Effective Dates

For Nasdaq-listed companies, the compensation committee adviser and compensation committee authority requirements become effective on July 1, 2013. Nasdaq-listed companies will have until their first annual meeting after January 15, 2014, or, if earlier, October 31, 2014, to comply with other standards, including the compensation committee member independence standards and the requirement to have a compensation committee and charter (including any charter amendment to reflect the compensation committee authority requirements). Nasdaq-listed companies must certify compliance with the listing standards within 30 days after the applicable implementation deadline.

### Compensation Committee Establishment, Member Independence and Charter

The final Nasdaq listing standards with respect to compensation committee establishment, member independence and charter do not differ substantively from the standards as initially proposed. Nasdaq confirmed its intent to apply to compensation committee members the same standard that it applies to audit committee members under Rule 10A-3 of the Exchange Act. As such, compensation committee members of a Nasdaq-listed company are prohibited from accepting, directly or indirectly, any consulting, advisory or other compensatory fee from the listed company or any subsidiary (with the exception of 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)). There is no "look-back" requirement or *de minimis* exception with respect to the receipt of fees.

In response to comments, Nasdaq confirmed that it was not proposing a ban on compensation committee member affiliations with the listed company. Nasdaq 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 there is no bright-line prohibition with respect to affiliation. Nasdaq cited its general independence standards as a sufficient requirement to have a listed company's board make an affirmative determination that no affiliate relationships exist that would impact independence.

### Advisers to Compensation Committees

The final Nasdaq listing standards with respect to compensation committee advisers are substantially aligned with the standards as initially proposed, but provide additional clarifications. In an amendment to the initial proposal, Nasdaq clarified that companies need only consider the six specified independence factors when evaluating adviser independence (unlike the catch-all evaluation required by the NYSE listing standards).

In a separate amendment, Nasdaq, like the NYSE, provided that a compensation committee is not required to conduct an independence assessment of an adviser who meets the exception in Item 407(e)(3)(iii) of Regulation S-K.[4] Nasdaq further clarified that the committee needs to consider the adviser independence factors when selecting or receiving advice from any compensation consultant, legal counsel or other adviser to the committee, other than in-house legal counsel or advisers that meet the Item 407(e) exemption. However, Nasdaq also confirmed that there is no requirement that advisers to the committee be independent; only that their independence be evaluated prior to their selection as advisers.

## What To Do Now

Now that the listing standards have been finalized, listed companies should:

- If not already underway, conduct a review of potential conflicts of interest with compensation consultants, because any such conflicts of interest are required to be disclosed in proxy statements for annual meetings that occur on or after January 1, 2013. As a reminder, this analysis is only required for compensation consultants and not for other advisers.
- By July 1, 2013:
  - Identify any advisers to the compensation committee, whether or not directly engaged by the compensation committee.
  - Gather the necessary data from directors, executive officers and advisers in order to evaluate the independence of advisers, and prepare to conduct such evaluations when new advisers are selected and at least annually thereafter for all existing advisers.
  - For NYSE-listed companies, review the compensation committee charter and implement any necessary changes to comply with the final listing standards.
  - For Nasdaq-listed companies, adopt a resolution giving the compensation committee authority to retain advisers (or consider amending the compensation committee charter).
- By the earlier of their first annual meeting after January 15, 2014 or October 31, 2014:
  - Have the board evaluate all compensation committee members to ensure that they meet the new independence requirements.
  - For Nasdaq-listed companies that do not already have a compensation committee, establish a compensation committee.
  - For all Nasdaq-listed companies, adopt a compensation committee charter or review the existing compensation committee charter and implement any necessary changes to comply with the final listing standards.

[4] As noted above, Item 407(e)(3)(iii) of Regulation S-K excepts an adviser whose role is limited to (a) consulting on any broad-based plan that does not discriminate in scope, terms or operation, in favor of executive officers or directors, and that is available generally to all salaried employees or (b) providing information that either is not customized or that is customized based on parameters that are not developed by the adviser, and about which the adviser does not provide advice.

DavisPolk

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.

## Executive Compensation and Employee Benefits


| | | |
|---|---|---|
| **Cynthia Akard** | **650 752 2045** | **cynthia.akard@davispolk.com** |
| **Beverly Fanger Chase** | **212 450 4383** | **beverly.chase@davispolk.com** |
| **Jeffrey P. Crandall** | **212 450 4880** | **jeffrey.crandall@davispolk.com** |
| **Edmond T. FitzGerald** | **212 450 4644** | **edmond.fitzgerald@davispolk.com** |
| **Kyoko Takahashi Lin** | **212 450 4706** | **kyoko.lin@davispolk.com** |
| **Jean M. McLoughlin** | **212 450 4416** | **jean.mcloughlin@davispolk.com** |
| **Gillian Emmett Moldowan** | **212 450 4273** | **gillian.moldowan@davispolk.com** |


## Corporate Governance


| | | |
|---|---|---|
| **Ning Chiu** | **212 450 4908** | **ning.chiu@davispolk.com** |
| **Joseph A. Hall** | **212 450 4565** | **joseph.hall@davispolk.com** |
| **William M. Kelly** | **650 752 2003** | **william.kelly@davispolk.com** |


**Any U.S. federal tax advice contained in this communication (including any attachments) is not intended to be used, and cannot be used, to avoid penalties under the Internal Revenue Code or to promote, market or recommend any transaction or matter addressed herein.**

## Appendix A

| Item | NYSE | Nasdaq |
|---|---|---|
| ***Effective Dates*** | ▪ 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.<br>▪ Other standards, including those that relate to the compensation committee adviser requirements and compensation committee charter requirements, become effective on July 1, 2013. | ▪ The listing standards relating to the compensation committee adviser independence and compensation committee authority requirements will become effective July 1, 2013.<br>▪ For all other listing standards (including any amendments to the compensation committee charter), the earlier of (i) the listed company's first annual meeting after January 15, 2014, or (ii) October 31, 2014.<br>▪ Within 30 days of the implementation deadline above, listed companies must certify that that they have complied with the amended listing standards on compensation committees. |
| ***Establishment of Compensation Committee*** | ▪ Already required by the NYSE's listing standards.<br>▪ There is no set number of directors required for the committee. | ▪ Compensation committee required. Must have at least two members.<br>▪ **Cure**: 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. |
| ***Compensation Committee Charter*** | ▪ Charter already required by the NYSE's listing standards.<br>▪ In addition to existing charter requirements, must specify the rights and responsibilities of the compensation committee regarding the authority to retain advisers and to provide funding for such advisers and the requirement that the committee consider independence factors before selecting any advisers.<br>▪ There is no express requirement to evaluate the charter annually. | ▪ Requirement to have a formal written compensation committee charter that specifies:<br>  ▪ the scope of responsibility and how it is carried out;<br>  ▪ responsibility for determining, or recommending to the board, the compensation of the CEO and all other executive officers;<br>  ▪ that the CEO may not be present during voting or deliberations regarding his or her compensation; and<br>  ▪ the rights and responsibilities of the compensation committee regarding the authority to retain advisers and to provide funding for such advisers and the requirement that the |

| | | |
|---|---|---|
| | | committee consider independence factors before selecting any advisers.<br>▪ The compensation committee must review and reassess the charter each year. |
| ***Compensation Committee Authority*** | ▪ Sole discretion to retain or obtain the advice of an adviser.<br>▪ Listed companies must provide funding for the retention of advisers. | ▪ Same as NYSE. |
| ***Compensation Committee Independence*** | ▪ Factors to be taken into consideration (no bright-line test):<br>▪ 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<br>▪ 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.<br>▪ **Cure**: 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. The NYSE must be promptly notified upon the compensation committee member ceasing to be independent. | ▪ Factors:<br>▪ <u>Prohibition</u> – 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<br>▪ <u>Consideration</u> – 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.<br>▪ **Exception**: 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.<br>▪ **Cure**: 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 until 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. |
| ***Compensation Committee Advisers*** | ▪ The compensation committee must consider *all* factors relevant to the adviser's independence from management, *including* the following six factors: | ▪ The compensation committee must consider the following six factors:<br>▪ the provision of other services to the listed company by the person that employs the adviser; |

| | | |
|---|---|---|
| | ▪ the provision of other services to the listed company by the person that employs the adviser;<br>▪ the amount of fees received from the listed company by the person that employs the adviser, as a percentage of the total revenue of the person that employs the adviser;<br>▪ the policies and procedures of the person that employs the adviser that are designed to prevent conflicts of interest;<br>▪ any business or personal relationship of the adviser with a member of the compensation committee;<br>▪ any stock of the listed company owned by the adviser; and<br>▪ any business or personal relationship of the adviser or the person that employs the adviser with an executive officer of the issuer. | ▪ the amount of fees received from the listed company by the person that employs the adviser, as a percentage of the total revenue of the person that employs the adviser;<br>▪ the policies and procedures of the person that employs the adviser that are designed to prevent conflicts of interest;<br>▪ any business or personal relationship of the adviser with a member of the compensation committee;<br>▪ any stock of the listed company owned by the adviser; and<br>▪ any business or personal relationship of the adviser or the person that employs the adviser with an executive officer of the issuer. |
| ***Exemption for Certain Advisers*** | ▪ In-house counsel; and<br>▪ Any compensation consultant, legal counsel or other adviser whose role is limited to the activities for which no disclosure would be required under Item 407(e)(3)(iii) of Regulation S-K: (a) consulting on any broad-based plan that does not discriminate in scope, terms or operation, in favor of executive officers or directors, and that is available generally to all salaried employees or (b) providing information that either is not customized or that is customized based on parameters that are not developed by the adviser, and about which the adviser does not provide advice. | ▪ Same as NYSE. |
| ***General Exemptions*** | ▪ Exemption for all listed companies, including controlled companies, that are currently exempt from the NYSE compensation committee requirements. | ▪ Exemption for all listed companies, including controlled companies, that are currently exempt from the Nasdaq compensation-related listing standards. |

| | | |
|---|---|---|
| ***Foreign Private Issuers*** | ▪ Exempt if the home country practice is followed.<br>▪ Existing listing standards already require disclosure of any significant corporate governance practices.<br>▪ Phase-in available for companies that cease to be FPIs (generally, six months from ceasing to qualify as an FPI, which is tested annually at the end of the most recent completed second fiscal quarter). | ▪ 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. |
| ***Newly Registered Companies in Connection with an IPO*** | ▪ No exemption.<br>▪ The existing transition period available for companies that list in connection with an initial public offering will continue to apply. | ▪ Same as NYSE. |
| ***Smaller Reporting Companies*** | ▪ Exempt from the compensation committee independence requirements and the compensation committee adviser independence requirements.<br>▪ Subject to the compensation committee authority provisions.<br>▪ Phase-in available for companies that cease to be smaller reporting companies (generally, six months from ceasing to be a smaller reporting company, except that with respect to compensation committee independence the phase-in extends through a one-year period; smaller reporting company status is tested annually at the end of the most recent completed second fiscal quarter). | ▪ Same as NYSE.<br>▪ Subject to the requirement to establish a compensation committee.<br>▪ Subject to the written compensation committee charter requirement, provided it can be in a board resolution and is not required to be reviewed annually. |