

SEC Approves NYSE and Nasdaq Compensation Committee Rules

If you have any questions regarding the matters discussed in this memorandum, please contact the following attorneys or call your regular Skadden contact.

Brian V. Breheny
Washington, D.C.
202.371.7180
brian.breheny@skadden.com

Marc S. Gerber
Washington, D.C.
202.371.7233
marc.gerber@skadden.com

Richard J. Grossman
New York
212.735.2116
richard.grossman@skadden.com

Neil M. Leff
New York
212.735.3269
neil.leff@skadden.com

Regina Olshan
New York
212.735.3963
regina.olshan@skadden.com

Erica Schohn
New York
212.735.2823
erica.schohn@skadden.com

Joseph M. Yaffe
Palo Alto
650.470.4650
joseph.yaffe@skadden.com

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Four Times Square, New York, NY 10036
Telephone: 212.735.3000

WWW.SKADDEN.COM

The Securities and Exchange Commission (SEC) recently approved new New York Stock Exchange (NYSE) and Nasdaq Stock Market (Nasdaq) listing requirements relating to compensation committees of listed companies. The listing requirements were added pursuant to the Dodd-Frank Act and:

- enhance the independence requirements for compensation committee members;
- specify compensation committee authority relating to compensation consultants, counsel and other advisers; and
- specify compensation committee responsibility to consider potential conflicts of interests when selecting compensation consultants, counsel and other advisers.

Timing

Companies have until the earlier of (1) their first annual meeting after January 15, 2014, or (2) October 31, 2014, to comply with the new compensation committee independence requirements.

- *Review Compensation Committee Composition.* Companies should review the composition of their compensation committees to assure compliance. As compensation committee members already are subject to independence requirements, many of them likely will continue to qualify as independent under the enhanced standards, although this may be less true under Nasdaq's listing requirements. Nevertheless, boards of directors will need to go through the process of considering compensation committee members' independence under the new rules.

Companies are required to comply with the other new standards, including those relating to the authority of compensation committees beginning July 1, 2013.

- *Adopt Required Charter Amendments.* By July 1, 2013, companies will need to review their compensation committee charter and make any changes necessary to comply with the new rules.
- *Consider Compensation Consultant Conflicts of Interests.* In the case of committee consideration of adviser conflicts of interest, notwithstanding the July 1, 2013, effective date of the listing standards, new SEC rules (as described in our alert titled "SEC Adopts Rules Requiring New Listing Standards for Compensation Committees," June 22, 2012) require disclosure in proxy statements for 2013 annual meetings as to whether retention of a compensation consultant raised any conflict of interest and how the conflict is being addressed. As a result, compensation committees currently should consider the listing requirements relating to adviser conflicts as they engage compensation consultants.

- *Consider Counsel and Other Adviser Conflicts of Interests.* By July 1, 2013, compensation committees will need to consider conflicts of interest before selecting counsel or other advisers.

Companies Subject to the Listing Standards

For both the NYSE and Nasdaq, the new listing requirements apply to companies with common equity securities listed on the exchange. As is currently the case, foreign private issuers may rely on home country standards and disclose how those standards differ from the exchange's standards applicable to U.S. companies. Smaller reporting companies are not wholly exempt from these rules, but are exempt from the enhanced independence standards and the committee responsibility to review consultant, counsel and adviser conflicts of interests. The NYSE and Nasdaq will continue to apply phase-in periods for companies in connection with their IPOs and exclude controlled companies, companies in bankruptcy, open-end management investment companies registered under the Investment Company Act of 1940 and limited partnerships.

- *Certification.* Nasdaq companies will have to certify to Nasdaq, no later than 30 days after the applicable deadline (the earlier of (1) their first annual meeting after January 15, 2014, or (2) October 31, 2014), that they have complied with the new compensation committee rules. While there is no new NYSE certification requirement, NYSE-listed companies will continue to provide annual written affirmations certifying compliance with the NYSE corporate governance listing standards.

Enhanced Compensation Committee Independence

NYSE. A member of the compensation committee of a NYSE-listed company is still required to qualify as an independent director under the NYSE's general standards on director independence. In addition, the committee member also must satisfy additional independence requirements. Specifically, the board of directors of the listed company would be required to affirmatively determine the independence of compensation committee members considering all factors "specifically relevant to determining whether a director has a relationship to the listed company which is material to that director's ability to be independent from management in connection with the duties of a compensation committee member." Those factors would include:

- *Source of director's compensation.* Compensation includes any consulting, advisory or other compensatory fees paid by the listed company to the director. The commentary provides that the board of directors should consider whether the director receives compensation from any person or entity that would impair the director's ability to make independent judgments about the listed company's executive compensation.
- *Affiliation with the listed company.* The commentary provides that the board of directors should consider whether an affiliate relationship places the director under the direct or indirect control of the listed company or its senior management or whether it creates a direct relationship between the director and senior management, in each case of a nature that would impair the director's ability to make independent judgments about the listed company's executive compensation.

The NYSE did not adopt any "bright-line" tests for compensation committee independence beyond the existing "bright-line" director independence standards.

Nasdaq. While the NYSE approach leaves room for board judgment, the Nasdaq approach on consulting and advisory fees is a "bright line" approach equivalent to the audit committee independence

standards. A member of the compensation committee for a Nasdaq-listed company must qualify as an independent director under Nasdaq's general standards of director independence and must not accept, directly or indirectly, any consulting, advisory or other compensatory fees from the listed company or any subsidiary of the company. For this purpose, compensatory fees exclude fees for board and committee service and fixed amounts of compensation under a retirement plan for prior service. As is the case for audit committee independence, there is no "look back" for the "no consulting, advisory or compensatory fees" test.

In addition, the board must consider whether the compensation committee member is affiliated with the company and whether such affiliation would impair the director's judgment as a member of the compensation committee. In commentary, Nasdaq states that ownership of company stock, even if a controlling interest, would not preclude a board determination of independence and that it may, in fact, be appropriate for representatives of significant stockholders to serve on compensation committees since their interests likely are aligned with other stockholders in seeking an appropriate executive compensation program.

Compensation Committee Authority/Required Charter Amendments

The Nasdaq listing requirement will require companies to have a compensation committee of at least two independent directors. Although Nasdaq currently provides an alternative where compensation matters could be handled by the independent directors as a group, most Nasdaq-listed companies already have a compensation committee with at least two independent directors.

Pursuant to the Nasdaq rules, the compensation committee must have a formal written charter. The charter would have to reflect the committee's responsibilities, including structure, processes and membership requirements, as well as the committee's responsibility for determining (or recommending to the board of directors for determination) the compensation of the company's chief executive officer and all other executive officers of the company. The charter also would need to specify that the company's chief executive officer may not be present during voting or deliberations on his or her compensation. And finally, the committee charter must specify the specific committee responsibilities and authorities to retain compensation consultants, legal counsel and offer advisers, at company expense, and to consider adviser conflicts. The committee is required to review and reassess the adequacy of the charter on an annual basis.

Pursuant to the NYSE rules, the compensation committee charter must be amended to reflect the rights and responsibilities of the compensation committee under the Dodd-Frank compensation committee rules. Although most NYSE-listed company charters already reflect the committee authority to retain consultants, counsel and advisers, most charters will need to be amended with respect to committee consideration of adviser conflicts.

Adviser Conflicts

Both the NYSE and Nasdaq listing standards will require compensation committee charters to reflect the committee's responsibility to consider conflicts of interest before selecting consultants, counsel or advisers. As set forth in the listing standards, the committee must take into consideration the following factors:

- the provision of other services to the listed company by the person that employs the compensation consultant, counsel or other adviser (the firm);
- the amount of fees received from the listed company by the firm as a percentage of total firm revenue;

- the firm's policies and procedures designed to prevent conflicts of interest;
- any business or personal relationship of the compensation consultant, counsel or other adviser with a member of the compensation committee;
- any listed company stock owned by the consultant, counsel or adviser; and
- any business or personal relationship of the consultant, counsel or adviser or the firm with an executive officer of the listed company.

Both the NYSE and Nasdaq specify that there is no need for the committee to undertake this review in connection with obtaining the advice of in-house legal counsel or any consultant, legal counsel or other adviser whose role is limited to activities for which no disclosure would be required under Item 407(e)(3)(iii) of Regulation S-K (consulting on broad-based plans and information that is not customized for a particular company or that is customized based on parameters that are not developed by the adviser and about which the adviser does not provide advice).

Importantly, both the NYSE and Nasdaq specify that the listing standards do not require a compensation consultant, counsel or other adviser to be independent, only that the compensation committee consider the enumerated factors before selecting or receiving advice. The NYSE and Nasdaq explicitly affirm compensation committees' ability to use any advisers preferred by the committee, regardless of independence.