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SEC Approves NYSE and Nasdaq Independence Standards for Compensation Committees and Advisers

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New listing standards for publicly traded companies require board compensation committees composed of directors that satisfy new independence standards by the first annual meeting after January 15, 2014, or, if earlier, October 31, 2014. The listing standards also require board charters to grant compensation committees, or independent directors setting executive compensation, the power to retain their own advisers by July 1, 2013. Compensation committees, or independent directors setting executive compensation, that retain advisers must evaluate adviser conflicts of interest by July 1, 2013.

On January 11, 2013, the Securities and Exchange Commission (SEC) approved new listing requirements proposed by the New York Stock Exchange LLC (NYSE) and NASDAQ Stock Market LLC (Nasdaq) regarding executive compensation. This is the final step in the SEC's implementation of Section 952 of the Dodd-Frank Wall Street Reform and Protection Act of 2010, which was discussed in a June 2012 Client Alert.[2]

Compensation Committee Requirements

For over a decade, the NYSE has required listed companies to maintain a compensation committee with the responsibility for setting executive compensation, or making recommendations to the board regarding executive compensation. For the first time, Nasdaq listing standards will mirror this requirement, necessitating a shift for companies who currently set executive compensation by a majority vote of their independent directors.

1 Law clerk awaiting admission to the bar.

2 June 28, 2012 Client Alert, SEC Adopts Independence Rules for Compensation Committees and Their Advisers.

By July 1, 2013, NYSE-listed companies, and Nasdaq-listed companies with compensation committees, must update their compensation committee charters to provide such committees with the authority to hire, pay, and supervise compensation consultants, attorneys, or any other needed advisers, at company expense. Nasdaq issuers without compensation committees must form a compensation committee and committee charter with the same provisions by their first annual meeting after January 15, 2014, or, if earlier, October 31, 2014.

Compensation Committee Member Independence

Both NYSE and Nasdaq companies have long been required to allocate executive compensation-setting responsibilities to independent directors, whether those directors were part of a formal compensation committee or not. The updated NYSE and Nasdaq listing standards impose new independence tests on top of those existing independent director standards.

The new NYSE standards require a board to determine that each compensation committee member is independent of company management based on all relevant factors including, but not limited to, (i) compensation from the company and (ii) affiliate relationships to the company, its subsidiaries or its subsidiaries' affiliates. The NYSE has confirmed that just one relationship may be cause for disqualifying a director from the compensation committee. It will be up to boards and their counsel to determine what factors, beyond director compensation and affiliate relationships, are relevant to committee member independence. Likely candidates include the tests for "outside directors" under Section 162(m) of the Internal Revenue Code of 1986 and "non-employee directors" under Section 16 of the Securities Exchange Act of 1934 (Exchange Act).

Under the new standards, Nasdaq company boards will have to limit compensation committee membership to directors whose independent judgment is not impaired by any affiliate relationship to the company, its subsidiaries, or its subsidiaries' affiliates. The new standards also prohibit compensation committee members from accepting any compensation from the company or its subsidiaries except directors' fees and qualified retirement plan benefits. This prohibition applies only while the director is a committee member; there is no look-back period. Notwithstanding the foregoing, a Nasdaq company may include in its compensation committee one director who cannot satisfy the new or existing independence tests if:

- the committee has three or more members,
- the non-independent member's participation is in the company's best interests, and
- the company publicly discloses its rationale for including a non-independent member.

Compensation Committee Adviser Independence

Starting July 1, 2013, compensation committees, and Nasdaq independent directors setting executive compensation, must annually evaluate the independence of their advisers. Both NYSE and Nasdaq require committees (or equivalent independent directors) to consider six factors, including relationships between the adviser's employer and the listed company, company stock held by the adviser, and any relationships between the adviser and either company officers or the committee members. NYSE's test also includes a catch-all, requiring committees to consider any other relevant independence factor.

Both exchanges' listing standards are clear that a committee (or equivalent independent directors) may consult non-independent advisers if it wishes. In addition, there is no need to evaluate the independence of in-house counsel and consultants who are excluded from the SEC's corporate governance disclosure requirements due to the limited nature of their work.

Committee and Adviser Exemptions

NYSE and Nasdaq listing standards currently exempt many entities, including controlled companies, limited partnerships, foreign companies, and registered investment management companies, from certain corporate governance requirements. These exemptions generally apply to the new compensation committee and adviser requirements. Additionally, smaller reporting companies (as defined in Rule 12b-2 under the Exchange Act) are generally exempt from the new requirements. Nasdaq-listed smaller reporting companies will, however, have to form compensation committees.

Compliance Steps for Listed Companies

All public companies should immediately assess the independence of compensation consultants (as opposed to compensation committee advisers). Under SEC rules, public companies must disclose any conflicts of interest raised by their compensation consultants in 2013 proxy statements prepared for annual shareholder meetings or special meetings at which directors will be elected.

Looking forward, a NYSE-listed company must:

- Update its compensation committee charter by July 1, 2013;
- Ensure that its compensation committee evaluates the independence of advisers whom it consults by July 1, 2013; and
- Evaluate the independence of all compensation committee members by the earlier of October 31, 2014 and the first annual meeting after January 15, 2014.

A Nasdaq-listed company must:

- Update its compensation committee charter, if one exists, by July 1, 2013;
- If no compensation committee exists, provide the independent directors setting executive compensation with the authority to retain advisers by July 1, 2013;
- Ensure that its compensation committee, or the independent directors setting executive compensation if no formal committee exists, evaluates the independence of advisers whom it consults by July 1, 2013;
- Establish a compensation committee and adopt a committee charter, if they do not already exist, by the earlier of October 31, 2014 and the first annual meeting after January 15, 2014; and
- Evaluate the independence of all compensation committee members by the earlier of October 31, 2014 and the first annual meeting after January 15, 2014.

The chart on the following pages summarizes the new listing standards.

If you have any questions about the content of this alert, please contact the Pillsbury attorney with whom you regularly work, or the authors below.

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New NYSE and Nasdaq Compensation Committee Independence Rules at a Glance

	NYSE	Nasdaq
Compensation Committee *NYSE deadline:* already applies *Nasdaq deadline:* earlier of post-Jan. 15, 2014 annual meeting and Oct. 31, 2014	• Committee composed entirely of 1+ independent directors.	• Committee must include 2+ independent directors. ▪ 1 non-independent director may serve for up to 2 years if committee has 3+ members, is in issuer's best interests, and issuer discloses rationale.
Compensation Committee Charter *NYSE deadline:* July 1, 2013 *Nasdaq deadline for issuer with committee:* July 1, 2013 *Nasdaq deadline for issuer w/out committee:* July 1, 2013 for providing independent directors with right to issuer-paid advisers, earlier of post-Jan. 15, 2014 annual meeting and Oct. 31, 2014 for enacting committee charter	• Committee charter required, which must describe the committee's: ▪ ability to, in its sole discretion, select, pay, and retain a compensation consultant, independent legal counsel, or other adviser; ▪ ability to determine reasonable amount of issuer funding needed to compensate advisers; ▪ obligation to consider adviser independence before consultation; and ▪ responsibilities, including to set or recommend CEO and executive officer compensation, all incentive compensation, and equity-based plans, subject to board approval, and to prepare required SEC disclosures.	• Committee charter required, which must describe the committee's: ▪ ability to, in its sole discretion, select, pay, and retain a compensation consultant, independent legal counsel, or other adviser; ▪ ability to determine reasonable amount of issuer funding needed to compensate advisers; ▪ obligation to consider adviser independence before consultation; ▪ responsibilities and how they will be carried out, including to set or recommend CEO and executive officer compensation; ▪ requirement to exclude the CEO from any deliberations or voting regarding his/her compensation; and ▪ obligation to reassess charter annually.
Compensation Committee Member Independence *NYSE deadline:* earlier of post-Jan. 15, 2014 annual meeting and Oct. 31, 2014 *Nasdaq deadline:* earlier of post-Jan. 15, 2014 annual meeting and Oct. 31, 2014	• Board must determine that committee members are independent from issuer executive officers based on: ▪ director's compensation from the issuer and any other related person or entity; ▪ the director's affiliate relationships to the issuer, issuer subsidiaries, or affiliates of issuer subsidiaries; and ▪ any other relevant factors.	• Board must determine that committee members' judgment will not be impaired by affiliate relationships to the issuer, issuer subsidiaries, or affiliates of issuer subsidiaries. • Committee members must not accept, directly or indirectly, compensation (except directors' fees and benefits under a qualified retirement plan for prior service) from the issuer or its subsidiaries while serving on the committee.
Cure Period for Loss of	• A member may remain on committee	• If a committee member either

	NYSE	Nasdaq
Committee Independence	if she ceases to be independent for reasons outside of her control, if: ▪ a majority of committee remains independent; ▪ non-independent member is replaced upon the earlier of (1) next annual meeting or (2) one year anniversary of loss of independence; and ▪ NYSE is promptly notified.	ceases to be independent for reasons outsider of his control or leaves his post, issuer: ▪ need not replace him until the earlier of (1) one year anniversary of loss of independence and (2) later of (a) next annual meeting and (b) 180 day anniversary of loss of independence; and ▪ must notify Nasdaq.
Compensation Committee Adviser Independence *NYSE deadline:* July 1, 2013 *Nasdaq deadline:* July 1, 2013 (applies to independent directors until formal committee in place)	• Prior to engaging non-exempt adviser, committee must evaluate adviser's independence based on: ▪ other services provided to issuer by adviser's employer; ▪ ratio of fees received by adviser's employer from (i) committee and (ii) issuer for other services; ▪ conflict of interest policies at adviser's employer; ▪ business or personal relationships between adviser and committee members; ▪ issuer stock owned by adviser; ▪ business or personal relationships between adviser and issuer executive officers; and ▪ other factors relevant to adviser's independence from management.	• Prior to engaging non-exempt adviser, committee must evaluate adviser's independence based on: ▪ other services provided to issuer by adviser's employer; ▪ ratio of fees received by adviser's employer from (i) committee and (ii) issuer for other services; ▪ conflict of interest policies at adviser's employer; ▪ business or personal relationships between adviser and any committee members; ▪ issuer stock owned by adviser; and ▪ business or personal relationships between adviser and issuer executive officers.
Exemptions from Committee Adviser Independence	• Committees may rely on an adviser without considering her independence if she is exempt because the adviser is: ▪ Issuer's in-house counsel; ▪ limited to consulting on plans generally available to salaried employees that do not discriminate in favor of executive officers or directors; or ▪ limited to providing information only, not advice, which is generalized or based on parameters not set by adviser.	• Same adviser independence exemptions as NYSE
Small Company Exemption	• New requirements regarding independence of committee members and advisers do not apply to smaller reporting companies, as that term is defined in Exchange Act Rule 12b-2.	• Smaller reporting companies, as defined in Exchange Act Rule 12b-2, are exempt from all new requirements except requirements for:

	NYSE	Nasdaq
		▪ compensation committee with at least 2 directors who are independent under existing Nasdaq Rule 5605(a)(2) standards; and ▪ written compensation committee charter or equivalent board resolution.
Transition for Former Small Companies	• Smaller reporting companies with a float of $75M+ at end of fiscal Q2 lose exemption upon conclusion of that fiscal year and must: ▪ adhere to compensation committee adviser requirements in 6 months; ▪ have 1 independent compensation committee member in 6 months; and ▪ have fully independent compensation committee in 1 year.	• Smaller reporting companies with a float of $75M+ at end of fiscal Q2 lose exemption upon conclusion of that fiscal year and must: ▪ adhere to compensation committee adviser requirements in 6 months; ▪ have 1 independent compensation committee member in 6 months; ▪ have fully independent compensation committee in 1 year; and ▪ adopt written committee charter in 6 months.