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SEC FINALIZES NYSE AND NASDAQ RULES REGARDING COMPENSATION COMMITTEE AND COMPENSATION ADVISER REQUIREMENTS

January 22, 2013

Earlier this month, the Securities and Exchange Commission (the "SEC") finalized rules approving the New York Stock Exchange LLC ("NYSE") and The NASDAQ Stock Market LLC ("NASDAQ") proposals regarding compensation committee independence and compensation adviser requirements.[1] As discussed below, listed companies must comply with certain provisions of the new rules by July 1, 2013, so companies that have not already done so should promptly assess actions that must be taken in order to timely comply with the new rules. The remainder of this alert summarizes the key provisions of the new rules.

Background

As mandated by the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the "Dodd-Frank Act"), in June 2012, the SEC adopted Rule 10C-1 under the Securities Exchange Act of 1934, as amended (the "Exchange Act"). Rule 10C-1 requires national securities exchanges to adopt listing rules consistent with the compensation committee and compensation adviser requirements imposed under the Dodd-Frank Act. In response, the NYSE [2] and the NASDAQ[3] proposed amendments to their listing standards, which were approved by the SEC[4] earlier this month.

Final NASDAQ Rules

The final NASDAQ rules will modify current listing standards as described below:

Mandatory Compensation Committee. Listed companies will be required to have compensation committees and may no longer rely on the current alternative allowing a majority of the board's independent directors to act in place of a compensation committee. Listed companies currently lacking a compensation committee will have a grace period in which to establish a committee in compliance with the new rule. Compensation committees will be required to have a written charter that must address, among other items, the committee's

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[1] Our earlier client alerts describing the SEC, NYSE and NASDAQ rulemaking can be found at: http://www.wcsr.com/resources/pdfs/cs100912.pdf and http://www.wcsr.com/resources/pdfs/cs062612.pdf.

[2] Form 19b-4, as amended, filed by the NYSE with the SEC on October 1, 2012, available at http://www.nyse.com/nysenotices/nyse/rule-filings/pdf?file_no=SR-NYSE-2012-49&seqnum=2.

[3] Form 19b-4 filed by NASDAQ with the SEC on September 25, 2012, available at http://nasdaq.cchwallstreet.com/NASDAQ/pdf/nasdaq-filings/2012/SR-NASDAQ-2012-109.pdf.

[4] See Release No. 34-68639 regarding the final NYSE rules (January 11, 2013), available at: http://www.sec.gov/rules/sro/nyse/2013/34-68639.pdf, and Release No. 34-68640 regarding the final NASDAQ rules (January 11, 2013), available at: http://www.sec.gov/rules/sro/nasdaq/2013/34-68640.pdf.

responsibilities and the retention, funding and independence of compensation advisers, and the adequacy of the charter must be reviewed and reassessed on an annual basis.

Size and Independence of Compensation Committee. Compensation committees must be comprised of at least two directors, each of whom must be independent under the new and existing NASDAQ rules.

Prohibition Against Advisory Fees. NASDAQ will apply the advisory fee standard that currently applies to audit committees to compensation committees. This standard generally prohibits committee members from accepting consulting, advisory or other compensatory fees (other than for board service or under a retirement plan) from the listed company or its subsidiaries.

Compensation Committee Authority to Retain Advisers. The compensation committee of a listed company may retain an adviser at its discretion, will be responsible for such appointment, and the listed company will be required to provide adequate funding for any compensation adviser engaged by the compensation committee. In addition, the compensation committee must consider six specific factors described in Rule 10C-1[5] in assessing (at least annually) the independence of compensation advisers prior to retaining a compensation adviser. This requirement applies to compensation consultants, outside legal counsel or other advisers that provide advice to the compensation committee (even if the advice does not relate to executive compensation), other than in-house counsel. However, nothing in the rules expressly requires that the compensation adviser selected be independent, only that the independence factors be considered by the compensation committee prior to selection of an adviser. The compensation committee is not required to conduct an independence assessment for a compensation adviser that will act in a limited role (i.e., providing non-customized reports or consulting services related to a broad-based plan that does not discriminate in scope, term or operations in favor of a company's executive officers or directors).

Consideration of Affiliations in Independence Determination. Listed companies will be required to consider affiliations in determining whether a director is independent for compensation committee purposes but the final rules do not ban affiliated directors, such as representatives of significant shareholders, from being deemed independent by the board.

Non-independent Compensation Committee Members. Companies may continue to rely on the current NASDAQ exception that allows certain directors who are not independent to serve on the compensation committee for up to two years. However, this exception will only be available in limited circumstances where compensation committees consist of at least three board members, the non-independent director is not an executive officer or employee (or a family member of an executive officer) of the company and the non-independent director's membership on the compensation committee is in the best interests of the company and its shareholders.

Smaller Reporting Companies; Controlled Companies and Foreign Private Issuers. Smaller reporting companies will be exempt from the compensation committee independence requirements that relate to fees and affiliation (but will be required to have compensation committees comprised of at least two independent directors) and will have some relief regarding charter requirements applicable to advisers. Controlled companies will be exempt from the rules as they are currently exempt from NASDAQ's compensation-related listing rules. A phase-in period of a year will apply to companies ceasing to be controlled companies during

[5] These factors require the compensation committee to consider (a) all services provided by an adviser to the company, (b) the percentage of the adviser's revenue that comes from such services, (c) the adviser's procedures to prevent conflicts of interest, (d) any relationship between the adviser and members of the compensation committee, (e) the amount of company stock owned by the adviser and (f) any relationship between the adviser and an executive officer of the listed company.

which their compensation committees will be required to become fully independent. Foreign private issuers will continue to be allowed to follow their home country practices regarding compensation committee matters.

Exemptions. The existing exemptions that apply to asset-backed issuers, cooperatives, limited partnerships and registered investment companies will continue under the final NASDAQ rules.

Cure and Transition Periods. The final NASDAQ rules provide a cure period that is the same as the cure period that currently applies for noncompliance with the requirement to have a majority of independent directors. If a listed company fails to comply with the compensation committee composition requirements due to one vacancy, or a member is no longer independent due to circumstances beyond his reasonable control, the company must regain compliance by the earlier of the next annual shareholders meeting or one year from the occurrence of the event that cause the noncompliance. A listed company must provide prompt notice of its noncompliance to NASDAQ.

Effective Date. The final NASDAQ rules which relate to the responsibilities and authority of the compensation committee will be effective on July 1, 2013. Companies must comply with the remaining final NASDAQ rules by the earlier of their first annual meeting held after January 15, 2014 or October 31, 2014.

Final NYSE Rules

In many respects, the final NSYE rules are similar to the final NASDAQ rules. In particular, the final NYSE rules will amend the NYSE's listing requirements as described below:

Compensation Committee Member Independence Standards. The final NYSE rules expand the existing director independence standards, which will apply specifically to compensation committee members and will require that a NYSE listed company consider all "relevant factors" that are material to determining whether a director is independent from management in connection with the duties of a compensation committee member, including, but not limited to, (a) the director's source of compensation (including advising and consulting fees paid to the director); and (b) whether such director is affiliated with the listed company, a subsidiary of the listed company or an affiliate of a subsidiary of the listed company. Under the director compensation factor, a listed company is required to consider whether the director receives compensation from any person or entity that would compromise his or her ability to make independent judgments on executive compensation matters. Similarly, a listed company will be required to consider whether affiliate relationships, if any, place the director under the direct or indirect control of the company or its senior management or create a direct relationship between the director and senior management that would impair the director's ability to make independent judgments on executive compensation issues. The NYSE does not list any specific numerical tests for this determination. In addition, the NYSE does not intend to prevent a company from finding a director to be independent under its standards merely because the director (or his or her affiliates) owns more than a certain percentage of the company's stock. The five NYSE bright line tests that are currently used to determine whether a director has a relationship with the listed company that impairs a finding of independence will continue to apply.

Compensation Committee Advisers. The final NYSE rules will allow a compensation committee to retain an adviser at its discretion, require the compensation committee to be directly responsible for the appointment and require companies to provide adequate funding for any compensation adviser engaged by the compensation committee. In addition, the final NYSE rules will require a compensation committee to consider the six factors listed in the SEC's Rule 10C-1(b)(4) regarding the selection of a compensation consultant, outside counsel or other adviser (described in footnote 5, above). In addition, companies will be required to address these rights and responsibilities in the compensation committee charter, and thus may need to update their charters to be consistent with the new NYSE requirements. The compensation committee of a listed company also will be required (at least annually) to conduct the independence assessment provided for under the NYSE listing standards and the compensation committee disclosures relating to compensation advisers under Regulation S-K. Furthermore, the final rule clarifies that nothing in the rules expressly requires that the compensation adviser selected be independent, only that the independence factors be considered by the compensation committee prior to selection of an adviser.

Smaller Reporting Companies; Controlled Companies and Foreign Private Issuers. Certain types of issuers are exempt from the final rules. For instance, smaller reporting companies will be exempt from the new compensation committee fees and affiliation independence standards and from the new requirement that compensation committees consider the additional independence factors for advisers, but will be subject to other aspects of the new NYSE compensation committee rules and will continue to be subject to the NYSE's general director independence standards. Companies that cease to qualify as smaller reporting companies will have a transition period to comply with these standards. The NYSE will extend the current exemption from compensation committee-related rules to controlled companies. Upon ceasing to be a controlled company, the company will have a year-long transition period during which its compensation committee will be required to become fully independent. Foreign private issuers will continue to be allowed to follow home country practices regarding director independence.

Exemptions. The existing exemptions that apply to asset-backed issuers, cooperatives, limited partnerships and registered investment companies will continue under the final NYSE rules.

Cure and Transition Periods. The final NYSE rules will allow a director serving on a compensation committee to continue his or her service on the compensation committee until the earlier of the next annual meeting of the company or one year from the date on which the member is no longer independent due to a reason outside of his or her reasonable control as long as the committee continues to have a majority of independent directors. A listed company must provide prompt notice of its reliance on the cure period to the NYSE. The NYSE will continue to afford newly listed companies transition periods to comply with listed company standards.

Effective Date. The final NYSE rules will be effective on July 1, 2013, with companies having until the earlier of their first annual meeting after January 15, 2014 or October 31, 2014 to comply with the new director independence rules. All other sections of the final NYSE rules will be effective as of July 1, 2013 for compliance purposes.

Action Items; Contact

Listed companies should review their compensation committee charters and director and officer questionnaires to confirm compliance with the final rules. Particular attention should be given to confirming the independence of each member of a company's compensation committee in accordance with the final rules. NASDAQ listed companies that have not already done so should establish a formal compensation committee with at least two independent members by the applicable deadline. Companies should also be ready to implement the newly enumerated responsibilities of the compensation committee by July 1, 2013. Further, listed companies should review their current relationships with compensation consultants, outside counsel and other advisers to determine whether such relationships are independent under the new standards and whether such engagements are made by the compensation committee, as opposed to the full board or management. Companies also should begin to assess the additional proxy statement disclosures that will be required as a result of the final rules and to incorporate the various assessments into their corporate governance calendars and procedures.

If you have any questions regarding the final rules, please contact Willie White (http://www.wcsr.com/lawyers/willie-j-white), the principal drafter of this client alert, or you may contact the Womble Carlyle attorney with whom you usually work or one of our Corporate and Securities attorneys at the following link: http://www.wcsr.com/profSearch?team=corporateandsecurities.