Cooley

February 8, 2013

In January of this year, the SEC finally approved the new listing standards proposed by the NYSE for independent compensation committees and compensation consultants, legal counsel and other advisers. These new listing standards, adopted as required under the Dodd-Frank Wall Street Reform and Consumer Protection Act and the SEC's implementing Rule 10C-1 under the Securities Exchange Act of 1934, are designed to promote the independence of compensation committee members, consultants and advisers. The SEC established a baseline of considerations for determining the independence of compensation committee members and consultants, but afforded substantial flexibility for the exchanges, subject to ultimate SEC approval, to formulate definitions or other requirements consistent with the SEC's rules. For the most part, the new NYSE listing standards adhere closely to the SEC's baseline and are largely congruent with the contemporaneously adopted new Nasdaq listing standards. In any case, application of the rules will raise interesting issues as boards of directors and compensation committees grapple with questions of whether potential conflicts of interest or other independence concerns should necessarily result in disqualification from service.

Listed companies will have until the earlier of their first annual meeting after January 15, 2014, or October 31, 2014, to comply with the new listing standards for compensation committee member independence. All other provisions will become effective on July 1, 2013. Accordingly, for calendar-year reporting companies, these rules will not have any impact on the 2013 proxy season.

SEC Rule 10C-1

SEC Rule 10C-1 directs the exchanges to adopt listing standards for public company boards of directors and compensation advisers that address the following:

- The independence of the members of a compensation committee;
- The committee's authority to retain compensation advisers;
- The committee's consideration of the independence of any compensation advisers; and
- The committee's responsibility for the appointment, compensation and oversight of the work of any compensation adviser.

Enhanced independence of compensation committee members

As directed by SEC rules, the NYSE's listing standards will now require that each member of a compensation committee be independent, applying a standard of "enhanced independence."

Under current NYSE listing standards, in addition to several enumerated bright-line tests, no director qualifies as "independent" unless the board of directors makes an affirmative general determination that the director has no material relationship with the listed company (directly or indirectly as a partner, shareholder or officer of an organization that has a relationship with the company). This broad determination requires the board to consider all of the facts and circumstances, and Commentary currently in the NYSE Manual highlights that "the concern is independence from management."

The new NYSE listing standards build on this subjective general determination. Under the new listing standards, in making the required affirmative determination of the independence of any director who will serve on the compensation committee, the board "must consider 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,"* (emphasis added), including, but not limited to, the following two factors:

- The source of compensation of the director, including any consulting, advisory or other compensatory fee paid by the listed company to the director (referred to as the "Fees Factor"), and
- Whether the director is affiliated with the listed company, a subsidiary of the listed company or an affiliate of a subsidiary of the listed company (referred to as the "Affiliation Factor").

Unlike the requirements for audit committee super-independence, however, the enhanced independence requirements for compensation committee members do not impose a mandatory disqualification from serving on the compensation committee in the event that a director fails to satisfy them. Rather, these are factors that the board must take into account in making an affirmative determination of enhanced independence.

Commentary to the new listing standard requires the board, in examining the director's sources of compensation under the Fees Factor, to consider "whether the director receives compensation from any person or entity that would impair his ability to make independent judgments about the listed company's executive compensation." (By contrast, the new Nasdaq listing standard contains an absolute prohibition on the acceptance, directly or indirectly, by a compensation committee member of any consulting, advisory or other compensatory fee from the listed company.) Similarly, with regard to affiliate relationships, the Commentary provides that the board should consider "whether the affiliate relationship places the director under the direct or indirect control of the listed company or its senior management, or creates a direct relationship between the director and members of senior management, in each case of a nature that would impair his ability to make independent judgments about the listed company's executive compensation." In contrast to the mandatory audit committee rules, the NYSE made clear that it did "not intend to adopt an absolute prohibition on a board making an affirmative finding that a director is independent solely on the basis that the director or any of the director's affiliates are shareholders owning more than some specified percentage of the listed company." In that regard, the NYSE has previously indicated that share ownership may indeed align "the director's interests with those of unaffiliated shareholders, as their stock ownership gives them the same economic interest in ensuring that the listed company's executive compensation is not excessive."

The NYSE elected not to adopt additional requirements to consider any other specific factors or impose any other specific numerical tests, relying instead on the existing general directive to consider any other material relationships between the director and the listed company or management. The adopting release confirms that a director can be disqualified as not independent on the basis of a single factor alone, if sufficiently material.

Committee composition cure period

If a member of a compensation committee ceases to be independent for reasons outside the member's reasonable control, so long as the committee continues to have a majority of independent directors, that person, with notice by the company to the applicable exchange, may remain a compensation committee member until the earlier of the next annual shareholders meeting or one year from the occurrence of the event that caused the member to no longer be independent. The purpose of the limitation to circumstances where there remains an independent majority is to avoid actual or apparent conflicts of interest by ensuring "that the applicable committee could not take an action without the agreement of one or more independent directors."

Observations and commentary

- Although the compensation committee independence requirements will not become operative until 2014, companies should begin now to make assessments as to whether their current compensation committee members would be compromised or raise concerns under the enhanced independence standards for compensation committee members and consider whether other directors are available to replace any directors who may be determined not to be independent for this purpose. Although the new standards do not impose a mandatory disqualification if one of the factors is not satisfied, it remains to be seen whether institutional shareholders or proxy advisory firms, such as ISS and Glass Lewis, will *de facto* impose disqualification by withholding votes for compensation committee members and other tactics. Boards may want to develop their own internal (formal or informal) policies that address the consequences of circumstances that implicate either prong of the enhanced independence standards.

- Several commenters contended that the new standards should be more explicit in requiring the board to consider, as part of its director independence determination, personal or business relationships with management. However, the NYSE did not believe that further clarification was necessary given the explicit statement in the commentary that "the concern is independence from management. The SEC believes that the "flexibility provided in NYSE's new compensation committee independence standards provides companies with guidance, while allowing them to identify those relationships that might raise questions of independence for service on the compensation committee."
- The proposal received several comments suggesting that, because excessive board fees could also impair independence and incline a director toward approval of large executive pay packages, board fees (as well as compensation from other third parties) should also be considered as a "source of compensation" in determining whether a committee member is independent under the enhanced standards. While the NYSE rejected the idea that board fees were likely to be relevant (given that all outside directors are eligible for the same directors' fees), it did acknowledge that, to the extent that excessive board compensation might affect independence, the listing standard would require that the board consider compensation as one of the relevant factors in making its independence determination. The SEC noted that, because companies must disclose director compensation, investors will become aware of compensation that is excessive. Notably, Commentary advises boards to consider "compensation from any person or entity that would impair [the director's] ability to make independent judgments about the listed company's executive compensation."

Compensation committee advisers

The new NYSE listing standards require that specific new responsibilities and authority be included in the compensation committee charters of listed companies with respect to compensation consultants, legal counsel and other advisers. Compensation committees will, by charter provision, now need to be:

- authorized, in their sole discretion, to retain or obtain the advice of compensation consultants, independent counsel and other advisers;
- directly responsible for the appointment, compensation and oversight of the work of compensation consultants, independent legal counsel and other advisers retained by the committee;
- entitled to appropriate funding from the listed company to pay reasonable compensation to the committee's compensation consultants, independent legal counsel and other advisers; and
- authorized to select a compensation consultant, legal counsel or other advisor only after conducting an independence assessment, as discussed below.

Commentary makes clear that nothing in the new listing standards requires the compensation committee to implement or act consistently with the advice or recommendations of the compensation consultant, independent legal counsel or other adviser to the compensation committee or affects the ability or obligation of the compensation committee to exercise its own judgment in fulfillment of its duties.

Compensation adviser independence assessment

Although compensation committees are not required to select compensation consultants, legal counsel or other advisers that are "independent," the NYSE's new listing standard provides that they must, in making their selections, take into account the following six factors (which are identical to those enumerated in SEC rules), which bear upon independence:

- 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.

Although the compensation committee must also consider "all factors that would be relevant to the [adviser's] independence from management," the NYSE did not identify any specific additional factors that must be considered. Compensation committees must conduct independence assessments with respect to any compensation consultant, legal counsel (other than in-house legal counsel) or other adviser that provides advice to the compensation committee—even if not expressly engaged as an adviser or counsel to the committee—unless his or her role is limited to the following activities (for which no disclosure would be required under Item 407(e)(3)(iii) of Regulation S-K) :

- consulting on any broad-based plan that does not discriminate in scope, terms or operation in favor of executive officers or directors of the listed company, and that is available generally to all salaried employees; or
- providing information that either is not customized for a particular company or that is customized based on parameters that are not developed by the compensation consultant, and about which the compensation consultant does not provide advice.

Notably, this requirement is "not limited to advice concerning executive compensation." The SEC anticipates that compensation committees will conduct these independence assessments at least annually.

Commentary in the NYSE Manual also expressly states that the new listing standard should not be construed to require that a compensation consultant, legal counsel or other compensation adviser be independent, only that the compensation committee must consider the specific independence factors before selecting or receiving advice from the adviser. The Commentary emphasizes that compensation committees "may select or receive advice from any compensation adviser they prefer including ones that are not independent, after considering the six independence factors…."

Observations and commentary

- Although it is clear that compensation advisers are not required to be independent and that committees need only consider the independence factors before selecting an adviser, whether institutional shareholders, proxy advisory firms or other activists will pressure compensation committees into engaging only independent advisers remains an open question. Committees may want to begin to consider what principles will guide them in assessing the independence of both current and future advisers and whether they should adopt a formal or informal policy in that regard. The policy should include the committee's review of the policies of its advisers and prospective advisers to ensure that these advisers will be able to provide information requested by the committee and comply with any independence requirements imposed by the committee.
- Listed companies will need to review and revise their compensation committee charters before the July 1, 2013 deadline to ensure that they are compliant with the listing standards. While most compensation committee charters authorize the engagement of consultants, counsel and advisers, including funding by the company, few charters will provide for the independence assessment now required under the new listing standards. Compensation committees will also need to ensure that this assessment (which may involve review of standard questionnaires) becomes part of their regular policies and procedures before selecting new advisers or even receiving advice from any current or future consultants, counsel or advisers.
- Keep in mind that, under new SEC rules, if a compensation consultant played any role in determining or recommending the amount or form of executive or director compensation and the consultant's work has raised any conflict of interest, listed companies will now need to include disclosure in their annual meeting proxy statements regarding the nature of the conflict and

how it is being addressed. The disclosure requirement will be applicable beginning with the 2013 proxy season. As a result, companies will need to identify, based on the six enumerated factors, any conflicts that may exist with their current compensation consultants and consider how best to address those conflicts. Notably, this disclosure requirement does not apply to legal counsel or other advisers.

- The requirement to assess independence is applicable to any compensation consultant or legal counsel (other than in-house counsel) or other adviser that provides advice to the compensation committee, even if not expressly engaged as an adviser or counsel to the committee. For example, the assessment must be performed by the committee with respect to regular outside counsel, "including the company's regular securities or tax counsel" to the extent they give advice to the compensation committee, as well as compensation consultants or other advisers retained by management or the company.

Smaller reporting companies

Although smaller reporting companies will be required to maintain compensation committees, they will not be required to comply with the enhanced independence standards for members of compensation committees—the Fees Factor or the Affiliation Factor. Smaller reporting companies will need to comply with provisions related to the authority and responsibility of the committee to engage compensation consultants, legal counsel and advisers, with the exception of the requirement to assess their independence.

Exemptions

The categories of listed companies that are exempt from the NYSE's current compensation-related listing standards will also be exempt under the new standards. These include, among others, exemptions from the listing standard requirements for controlled companies (defined as companies in which more than 50% of voting power in the election of directors is held by an individual, a group or another company), as well as for limited partnerships and companies in bankruptcy. Foreign private issuers that follow their home country practices (in lieu of compliance with the NYSE's governance standards) will also be exempt, so long as they disclose annually any significant differences between their corporate governance practices and NYSE listing standards as applied to domestic companies.

Transition periods

As noted above, listed companies would have until the earlier of their first annual meetings after January 15, 2014, or October 31, 2014, to comply with the new compensation committee independence standards. All other provisions of the new listing standards, including requirements regarding the authority and responsibility of compensation committee members to assess adviser independence, will become effective on July 1, 2013 for currently listed companies.

In addition, the existing transitional phase-in periods available to newly listed companies (including companies listing in conjunction with an IPO, a spin-off or carve-out, companies listing after emerging from bankruptcy and companies that cease to qualify as controlled companies) would continue to be available for those companies with respect to the proposed new compensation committee requirements. Generally, this phase-in permits a gradual step-by-step transition to a committee that satisfies the enhanced independence requirements within one year of listing.

A company that ceases to be a smaller reporting company will have a slightly different phase-in schedule that also leads to a compensation committee with enhanced independence within one year of the date that the company ceases to be a smaller reporting company under SEC rules (the beginning of the fiscal year after its public float equals or exceeds $75 million). Companies that cease to be smaller reporting companies would also need to comply with the requirement to assess the independence of compensation committee advisers within six months of that cessation date.

Companies that cease to qualify as foreign private issuers will be required to have compensation committees that satisfy the enhanced independence standards within six months of the date of cessation. Similarly, companies transferring from another market would have one year to comply with those corporate governance requirements that were not required by their former exchanges.

If you have any questions about this *Cooley Alert,* please contact one of your Cooley team members or one of the attorneys identified above.

Key Contacts

Kenneth Guernsey San Francisco	kguernsey@cooley.com +1 415 693 2091
Cydney Posner San Francisco	cposner@cooley.com +1 415 693 2132
Sam Livermore San Francisco	slivermore@cooley.com +1 415 693 2113
Tom Reicher San Francisco	treicher@cooley.com +1 415 693 2381