SEC Approves NYSE and Nasdaq Rules on Independence of Compensation Committee Members and Advisers

January 31, 2013

Background of the Rules

To implement Section 10C of the Securities Exchange Act of 1934 (the Act), as added by the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank), the SEC adopted Rule 10C-1 which became effective on June 21, 2012.

The national securities exchanges have been directed to adopt listing standards which require that each member of the compensation committee must be a member of the board of directors and must be independent. In establishing these independence standards, the exchanges must consider relevant factors, including, but not limited to, the following factors:

- *the Fees Factor:* the source of compensation of the director, including any consulting, advisory or other compensatory fee paid by the issuer to the director

- *the Affiliation Factor:* whether the director is affiliated with the issuer, a subsidiary of the issuer or an affiliate of a subsidiary of the issuer.

Furthermore, compensation committees must be given the authority to retain or obtain the advice of a compensation adviser, and have direct responsibility for the appointment, compensation and oversight of the work of any compensation adviser they retain. Moreover, each issuer must provide appropriate funding for the payment of reasonable compensation, as determined by the committee, to any compensation adviser retained by the committee. The committee may select a compensation consultant, legal counsel or other adviser to the compensation committee only after taking into consideration six independence factors specified in Rule 10C-1, as well as any other factors identified by the exchange in its listing standards. The committee can select such an adviser even though the adviser may not satisfy these independence factors.

The exchanges had to submit any proposed changes to the compensation committee listing standards to the SEC for approval. On January 11, 2013, the SEC approved the proposals submitted by the NYSE and Nasdaq. The SEC has also approved revised compensation committee listing standards for other exchanges (e.g., BATS Exchange, Chicago Stock Exchange, NASDAQ OMX).

Compensation Committee Composition, Charter and Independence Standards

NYSE – Compensation Committee Composition and Charter

Current NYSE rules provide that each listed company must have a compensation committee and that the committee must be composed of independent directors (as determined in accordance with the NYSE's current bright-line tests). Under the revised rules, each compensation committee member must also satisfy additional independence requirements described below.

NYSE will continue to require that an issuer adopt a formal written compensation committee charter that specifies the scope of the committee's responsibilities and how it carries out those responsibilities, including structure, operations and membership requirements.

The amended rule requires the charter to specify additional responsibilities and authority with respect to retaining its own advisers; appointing, compensating, and overseeing such advisers; considering certain independence factors before selecting and receiving advice from advisers; and receiving funding from the company to engage them.

NYSE – Director Independence Standards

Current NYSE rules state that a director is not independent unless the board of directors affirmatively determines that the director has no material relationship with the listed company and meets the NYSE's general director independence standards.

Under the revised rules, when the board of directors affirmatively determines the independence of a compensation committee director, it must also consider all factors relevant to determining whether a director has a relationship with the company which is material to that director's ability to be independent from management in connection with the duties of a compensation committee member; factors to be considered include, but are not limited to, the Fees and Affiliation Factors.

With respect to the Fees Factor, NYSE will require that the board consider whether the director receives compensation from any person or entity that would impair his ability to make independent judgments about the company's executive compensation.

With respect to the Affiliation Factor, a board will have to consider whether an affiliate relationship places the director under the direct or indirect control of the company or its senior management, or creates a direct relationship between the director and members of senior management. The board would have to decide if such a relationship would impair the director's ability to make independent judgments about the company's executive compensation.

The NYSE did not propose any specific numerical tests with respect to compensation committee director independence or adopt a requirement that a board consider any other specific factors. Furthermore, there is no requirement that a board make an affirmative finding that a director is independent solely on the basis that the director or any of the director's affiliates are shareholders who own more than a specified percentage of the company's stock. However, a single factor or relationship could be material enough to require the board to find that the director is not independent.

NYSE also adopted a cure period if a member of the compensation committee ceases to be independent for reasons outside the member's reasonable control. So long as a majority of the members of the compensation committee continue to be independent, the conflicted director may remain a member of the compensation committee until the earlier of the next annual shareholders' meeting or one year from the occurrence of the event that caused the member to be no longer independent. A company relying on this provision would have to notify the NYSE promptly.

Nasdaq – Compensation Committee Composition and Charter

Under the new Nasdaq rules, each listed company will be required to have a compensation committee. A majority of the independent directors can no longer act in lieu of a compensation committee. The committee will have to have at least two members, each of whom must be independent directors (as determined in accordance with Nasdaq's general director independence standards) and meet the additional independence requirements described below.

A compensation committee must have a formal written charter. A listed company will have to certify (A) that it has adopted such a charter and (B) that its compensation committee will review and reassess the adequacy of that charter on an annual basis. The charter must specify:

- the scope of the committee's responsibilities and how it carries out those responsibilities, including structure, processes, and membership requirements;
- the committee's responsibility for determining or recommending to the board for determination, the compensation of the CEO and all other executive officers of the company, and prohibiting the CEO from being present during voting or deliberations on his or her compensation;
- the committee's responsibilities and authority with respect to retaining its own advisers and appointing, compensating, and overseeing such advisers;
- that the committee consider certain independence factors before selecting advisers; and
- that the committee will receive funding from the company to engage such advisers.

Nasdaq – Director Independence Standards

Under the revised rules, when the board of directors determines whether a compensation committee director is independent, the only additional factors to be considered are the Fees and Affiliation Factors as discussed below.

With respect to the Fees Factor, each member of a compensation committee of a listed company must not accept directly or indirectly any consulting, advisory or other compensatory fee from the listed company or any of its subsidiaries. This provision is similar to the Nasdaq audit committee rule which prohibits an audit committee member from accepting such fees.

The rule allows a committee member to receive fees for his or her membership on the committee, on the company's board, or on any other board committee. Moreover, a compensation committee member will be permitted to receive fixed amounts of compensation under a retirement plan (including deferred compensation) for prior service with the company; such compensation must not be contingent on continued service. When conducting this analysis, the board does not have to look back at compensation received by the director in the past. It need only review payments made to a director while serving on the committee.

With respect to the Affiliation Factor, the company's board must consider whether the director is affiliated with the company, a subsidiary of the company, or an affiliate of a subsidiary of the company. If such an affiliation exists, the board must decide whether such affiliation would impair the director's judgment as a member of the compensation committee. This rule does not prohibit a committee member from being an affiliated person of the issuer or any subsidiary. In the Nasdaq's view, certain affiliates, such as representatives of significant shareholders, may serve on compensation committees since their interests are likely aligned with those of other stockholders in establishing and maintaining an appropriate executive compensation program. Furthermore, there is no requirement that a board make an affirmative finding that a director is independent solely on the basis that the director or any of the director's affiliates are shareholders who own more than a specified percentage of the company's stock.

Nasdaq elected not to propose further independence requirements with respect to compensation committee director independence.

Nasdaq has adopted a cure period if there is one vacancy, or if one compensation committee member ceases to be independent due to circumstances beyond the member's 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 caused the noncompliance. The company must provide notice to Nasdaq immediately upon learning of the event that caused the noncompliance.

However, if the annual shareholders meeting occurs no later than 180 days following the event that caused the noncompliance, the company will have 180 days from the event to regain compliance.

Nasdaq's current rules include an exception that allows a director who is not independent to be appointed to the compensation committee under exceptional and limited circumstances, as long as that director is not currently an executive officer, an employee, or the family member of an executive officer. The exception applies, however, only if the committee is comprised of at least three members, the company's board determines that the individual's membership on the committee is required by the best interests of the company and its shareholders and the company applies with the other provisions of the exemption. This exception will continue to be available and allows a listed company to rely on this exemption even for a director who fails to meet the new requirements regarding the Fees and Affiliation Factors.

Compensation Committee Advisers

NYSE

The NYSE's amended rules provide that the compensation committee: (i) may, in its sole discretion, retain or obtain the advice of a compensation consultant, independent legal counsel or other adviser; and (ii) shall be directly responsible for the appointment, compensation and oversight of the work of any compensation consultant, independent legal counsel or other adviser retained by the committee. Furthermore, the company must provide for appropriate funding, as determined by the compensation committee, for payment of reasonable compensation to a compensation consultant, independent legal counsel or any other adviser retained by the committee.

Before selecting, or receiving advice from, a compensation consultant, legal counsel or other adviser to the committee, other than in-house legal counsel, the compensation committee must take into consideration all factors relevant to that person's independence from management, including the six factors set forth in Rule 10C-1. The six factors (the "onsultant Independence Factors), which a committee must consider, are:

- the provision of other services to the company by the person that employs the compensation consultant, legal counsel or other adviser;
- the amount of fees received from the company by the person that employs the compensation consultant, legal counsel or other adviser, as a percentage of the total revenue of the person that employs the consultant, legal counsel or other adviser;
- the policies and procedures of the person that employs the compensation consultant, legal counsel or other adviser that are designed to prevent conflicts of interest;
- any business or personal relationship of the compensation consultant, legal counsel or other adviser with a member of the compensation committee;
- any stock of the listed company owned by the compensation consultant, legal counsel or other adviser; and
- any business or personal relationship of the compensation consultant, legal counsel, other adviser or the person employing the adviser with an executive officer of the company.

The revised rule does not include any specific additional factors that the committee must consider. The rule does direct the compensation committee to consider any other factors that would be relevant to the adviser's independence from management. The SEC expects that this evaluation will be made annually.

A compensation committee does not have to conduct the independence assessment discussed above with respect to: (i) in-house legal counsel and (ii) 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 (the "407(e)(3)(iii) Exception"). These activities are: (a) 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; and/or (b) 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. Thus, advisers who provide general compensation surveys need not be subject to the independence analysis.

Outside counsel must be evaluated using the Consultant Independence Factors before they can serve as an adviser to the committee.

It should be noted that nothing in the rule requires a compensation consultant, legal counsel or other compensation adviser to be independent, only that the compensation committee consider the Consultant Independence Factors before selecting or receiving advice from a compensation adviser. A committee is allowed to select or receive advice from any compensation adviser it prefers, including ones that are not independent, after considering the Consultant Independence Factors.

Nasdaq

The Nasdaq rules, as amended, provide that the compensation committee: (i) may, in its sole discretion, retain or obtain the advice of a compensation consultant, independent legal counsel or other adviser; and

(ii) shall be directly responsible for the appointment, compensation and oversight of the work of any compensation consultant, independent legal counsel or other adviser retained by the committee. In addition, the listed company must provide for appropriate funding, as determined by the committee, for payment of reasonable compensation to a compensation consultant, independent legal counsel or any other adviser retained by the committee.

The compensation committee may select, or receive advice from, a compensation consultant, outside legal counsel or other adviser to the compensation committee, only after taking into consideration the Consultant Independence Factors. The SEC expects that this evaluation will be made annually.

Nothing in the new rule requires a compensation consultant, legal counsel or other compensation adviser to be independent; it only requires that the compensation committee consider the Consultant Independence Factors before selecting, or receiving advice from, a compensation adviser. Therefore, a committee may select, or receive advice from, any compensation adviser it prefers, including ones that are not independent, after considering the Consultant Independence Factors.

A compensation committee is not required to conduct an independence assessment for in-house counsel or a compensation adviser that acts in a role limited to the activities for which no disclosure is required under the 407(e)(3)(iii) Exception. Thus, advisers who provide general compensation surveys need not be subject to the independence analysis.

Smaller Reporting Companies

NYSE

As permitted by Rule 10C-1, the NYSE has adopted a rule which states that a Smaller Reporting Company, as defined in Rule 12b-2 under the Act (a company with a public float of less than $75 million), will not be subject to the requirements set forth in the revised NYSE rules.

As a consequence, Smaller Reporting Companies will not have to comply with the enhanced independence standards for members of compensation committees relating to the Fees or Affiliation Factor or apply the Consultant Independent Factors when selecting advisers.

A Smaller Reporting Company will be required to comply with the pre-existing NYSE compensation committee rules, including the requirements relating to the compensation committee’s authority, responsibility and funding of compensation advisers.

Nasdaq

The amended Nasdaq rule provides that a Smaller Reporting Company will not be subject to the requirements set forth in its revised rules. Therefore, a Smaller Reporting Company will not have to comply with the enhanced independence standards for members of compensation committees relating to the Fees and Affiliation Factors or apply the Consultant Independent Factors when selecting advisers.

In addition, a Smaller Reporting Company will not be required to include in its compensation committee charter a grant of authority to the committee to retain compensation advisers, a requirement that the company fund such advisers, or a requirement that the committee consider independence factors before selecting such advisers. Furthermore, the compensation committees of such companies will not be required to review and reassess the adequacy of their charters on an annual basis.

A Smaller Reporting Company will be required, however, to have, and to certify that it has and will continue to have, a compensation committee of at least two members, each of whom is independent under existing director independence standards. It will also have to have a written charter.

Exemptions

NYSE

The NYSE's existing exemptions from its compensation-related listing rules will apply to the new requirements of the amended rules. These include exemptions to the following issuers: any listed company of which more than 50% of the voting power for the election of directors is held by an individual, a group or another company (in other words, a controlled company); limited partnerships; companies in bankruptcy; closed-end and open-end management investment companies that are registered under the Investment Company Act of 1940; passive business organizations in the form of trusts (such as royalty trusts) or derivatives and special purpose securities; and issuers whose only listed equity stock is a preferred stock.

NYSE's current rules for foreign private issuers permit any such issuer to follow its home country practice in lieu of complying with many of NYSE's corporate governance listing standards, including the NYSE's compensation-related listing rules. Foreign private issuers are permitted to follow home country practice rather than the NYSE rules, but the issuer must disclose in its annual report filed with the SEC any significant ways in which its corporate governance practices differ from those followed by domestic companies under NYSE listing standards. This exemption will apply to the revised compensation committee rules provided the issuer makes the requisite disclosures.

Nasdaq

Nasdaq's existing exemptions from the its compensation-related listing rules will apply to the new requirements of the revised rules. These include exemptions for asset-backed issuers and other passive issuers, cooperatives, limited partnerships, management investment companies registered under the Investment Company Act of 1940 and controlled companies.

Nasdaq's current rules permit a foreign private issuer to follow its home country practice in lieu of many of Nasdaq's corporate governance listing standards, including Nasdaq's compensation-related listing rules. The issuer must disclose in its annual report filed with the SEC each requirement that it does not follow and describe the home country practice followed by the issuer in lieu of such requirement. This exemption will apply in most cases to the revised compensation committee rules provided the issuer makes the requisite disclosures. However, with respect to the Fees Factor and the Affiliation Factor if a listed company follows its home country practice, it must additionally disclose in its annual report filed with the SEC the reasons why it does not have an independent compensation committee as set forth in these standards.

Transition Rules for Listed Companies

NYSE

NYSE listed companies will be required to comply with the new compensation committee director independence standards by the earlier of their first annual meeting after January 15, 2014, or October 31,

2014. Existing compensation committee independence standards would continue to apply pending the transition to the new standards. On July 1, 2013, issuers not otherwise exempted from the new rules will be required to comply with the provisions relating to the authority of a compensation committee to retain compensation consultants, legal counsel, and other compensation advisers; the authority to fund such advisers; and the responsibility of the committee to consider Consultant Independence Factors before selecting or receiving advice from such advisers.

Nasdaq

Commencing on July 1, 2013, Nasdaq listed companies will be required to comply with the provisions of the proposed rule change relating to the authority of a compensation committee to retain compensation consultants, legal counsel, and other compensation advisers; the authority to fund such advisers; and the responsibility of the committee to consider the Consultant Independence Factors before selecting such advisers. To the extent a company does not yet have a compensation committee by that date, these provisions will apply to the independent directors who determine, or recommend to the board for determination, the compensation of the CEO and all other executive officers of the company.

Regarding the remaining new independence standards for compensation committees, companies will have until the earlier of their first annual meeting after January 15, 2014, or October 31, 2014, to comply with these provisions. A listed company must certify to Nasdaq, no later than 30 days after the final implementation deadline applicable to it, that it has complied with the rules.

For further information on these new rules, please contact Tim Sullivan, Michael D. Morehead or your regular Hinshaw attorney.
