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Stock Tips: Inside The New Exchange Listing Standards

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Law360, New York (June 13, 2013, 11:27 AM ET) -- In theory, a company could be delisted from a national stock exchange as a result of a chance meeting anywhere and a casual conversation, if a compensation committee member receives from company counsel any legal advice regarding company compensation. Beginning on July 1, 2013, the listing standards of national securities exchanges and national securities associations mandated by Section 952 of the Dodd-Frank Act becomes effective.

Under these standards, compensation committees of issuers listed on national securities exchanges are required to consider specified independence factors prior to the committee's retention of or obtaining advice from a compensation consultant, outside legal counsel or other adviser. If the compensation committee, or a committee member, receives legal advice, necessarily of a focused compensation-based content, with the issuer's current outside legal counsel, the exchange's listing standards require the committee to have conducted an independence assessment prior to obtaining that advice from such counsel.

The specified independence factors are: (1) the provision of other services to the issuer by the person [law firm] that employs the adviser; (2) the amount of fees received from the issuer by the person that employs the adviser, as a percentage of the total revenue of the person that employs the adviser; (3) the policies and procedures of the person that employs the adviser that are designed to prevent conflicts of interest; (4) any business or personal relationship of the adviser with a member of the committee; (5) any stock of the issuer owned by the adviser; and (6) any business or personal relationship of the adviser or the person employing the adviser with an executive officer of the issuer.

The statutory provisions, the U.S. Securities and Exchange Commission regulations thereunder and the exchanges' listing standards simply require the compensation committee to consider the independence factors; the committee can still choose to retain or obtain the advice of counsel or other adviser that is not independent, as long as the committee had previously considered the factors.

The Independence Requirement

Section 952, which codified Section 10C of the Securities Exchange Act of 1934, required the SEC to issue regulations, which became Rule 10C-1, mandating the national securities exchanges and national securities associations to adopt listing standards that require the compensation committee to be comprised solely of independent directors; authorize the compensation committee to retain, compensate and oversee the work of independent advisers, including independent legal counsel; and mandate listed issuers to fund the reasonable compensation requests of the compensation committee.

Under the new listing standards, retaining independent legal counsel is rather mundane — conduct an interview with the firm, consider the specified independence factors and determine to retain (or not). But how does current outside counsel fit within this paradigm? In view of the breadth of "obtaining the advice of independent legal counsel" and the potential risk of not conducting an interview, a compensation committee will be well served if it conducts the independence interview before July 1, 2013 — and if that is not possible, as soon as possible and before obtaining any legal advice from that counsel.

Noncompliance Risk; Cure Provisions

In fact, is there really any "downside risk" for the committee or a committee member obtaining the advice of legal counsel prior to the committee's consideration of the specified independence factors? Section 10C(a)(1) provides expressly that "the commission shall, by rule, direct the national securities exchanges and national securities associations to prohibit the listing of any equity security of an issuer that is not in compliance with the requirements of this section." Rule 10C-1(a) thereunder provides a similar prohibition, although the rule expands upon Section's 10C prohibition to "must prohibit the initial or continued listing."

Both Section 10C and the rule expressly reference the retention as well as "obtaining the advice of" independent legal counsel and require the committee to consider the independence factors prior to retaining or obtaining the advice of independent legal counsel. So, it is at least arguable that Congress and the SEC, acting upon the mandate of Congress, meant what the words of the statute and the derivative regulation expressly provide: that the listing, whether initial or continued, of an equity security on a national stock exchange must be prohibited if the issuer "does not comply with the requirements of" Section 10C or the rule.

Although Section 10C and the rule state that the listing standards to be adopted by the national securities exchanges "shall provide for appropriate procedures for an issuer to have a reasonable opportunity to cure any defects that would be a basis for prohibition," the listing standards of the New York Stock Exchange, the Nasdaq Stock Market and the NYSE MKT LLC, the successor to the American Stock Exchange, adopted under the rule afford an opportunity to cure regarding only the composition of the compensation committee.

The three exchanges advised the SEC in their adopting the new listing standards that they will rely upon their respective internal policies and procedures to reconcile noncompliance situations, based upon the facts and circumstances of each matter. One should probably conclude that consequent delisting is unlikely, in view of the curative provisions within Section 10C, the rule and such internal policies and procedures. And in fact, delisting solely under these circumstances would be a truly draconian result for the faux pas of such noncompliance, although in egregious circumstances one might suppose that delisting could be possible.

Notification and Enforcement

By Section 303A.12 "Certification Requirements," the NYSE requires each listed company CEO to certify to the NYSE annually that he or she is not aware of any violation by the listed company of any NYSE corporate governance listing standard. That section further requires the CEO to promptly notify the NYSE in writing after any executive officer of the listed company "becomes aware of any non-compliance with any applicable provisions of" Section 303A, the corporate governance section of the NYSE listing standards.

Likewise, the Nasdaq listing standards in Section 5625 “Notification of Noncompliance” require a listed company to provide Nasdaq with prompt notification after an executive officer of the company “becomes aware of any noncompliance by the Company with the requirements of” the Rule 5600 Series, the corporate governance provisions of the Nasdaq listing standards. Whether or not the NYSE or Nasdaq would ever bring an enforcement action against a company that is not in compliance with the independence assessment obligation remains to be seen. Presumably, after receiving notice of noncompliance from the company, the exchange would commence an inquiry as to the circumstances behind such noncompliance.

Best Practices Regarding Assessment

A second issue is how often must a compensation committee conduct an independence assessment with its outside legal counsel to be confident that the committee will conform to the spirit as well as the letter of the listing standards. Although Section 10C, Rule 10C-1 and the listing standards are silent, the SEC has stated that it contemplates that compensation committees will conduct such an independence assessment at least annually. It would be sound, conservative practice for the compensation committee to conduct that interview on a regular basis, such as annually in the beginning of January.

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