

Public Company Series

Board Structure and Composition





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Meeting SEC and stock exchange criteria for boards and committees

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Introduction

Stockholders own corporate entities but elect a board of directors to govern the company. The board is responsible for overseeing the general management of the company's business (for the benefit of the stockholders) and—except for certain matters reserved for stockholders—has decision-making authority over the company's affairs. Directors, in turn, delegate much of the day-to-day operational matters of running the business to officers of the company, who hire employees and engage other third-party consultants and advisors. Boards must approve most major corporate actions that involve significant financial, legal, or tax consequences, including—for example—distributions, hiring and firing of senior officers, operating budgets, amending the company's organizational documents, borrowing or lending money, changes to employee benefit plans, and any major sale or merger transaction.

Committees are critical in helping a board of directors meet the many obligations that come with overseeing a public company. Federal law and stock exchange rules set standards and qualifications with which public company board committees must comply. The following is a summary of those requirements.

Overview of stock exchange corporate governance and board composition requirements

The stock exchanges impose corporate governance and board composition requirements as part of their respective listing standards. Foreign private issuers

and controlled companies are exempt from some of these standards. A “controlled company” is one in which more than 50% of the voting power for the election of directors is held by an individual, a group, or another company.

Below is a summary highlighting the stock exchange board composition requirements.

Stock exchange corporate governance requirements

In addition to the quantitative and maintenance listing standards of the stock exchanges, a company must meet certain

Exchange requirement	Foreign private issuers	Controlled companies	Emerging Growth Companies (EGCs) and Non-EGCs
• Majority of independent directors	May follow home-country practice	Not required	Yes, within 12 months of listing
• Fully independent nominating/corporate governance committee	Same as above	Same as above	Yes ¹
• Fully independent compensation committee	Same as above	Same as above	Yes ¹
• Fully independent audit committee <ul style="list-style-type: none">• Must meet requirements of Rule 10A-3²• Must have at least three members	Yes	Yes	Yes
	May follow home-country practice	Yes	Yes

¹ The requirements for these committees are:

- one independent director on each committee at the time of listing;
- a majority of independent directors within 90 days thereafter; and
- fully independent committees within one year.

² The following transition periods apply to all initial public offering (IPO) companies:

- for the first 90 days after an IPO, all but one member of the audit committee are exempt from Rules 10A-3’s independence requirement; and
- for the first year after an IPO, a minority of the members of the audit committee are exempt from Rule 10A-3’s independence requirements. (Since most audit committees have three members, this means that only two need to be independent for the days 91 through 365 following the IPO.)

corporate governance standards for an initial listing, with two key exceptions:

- **Foreign private issuers.** Foreign private issuers are permitted to follow home-country practice in lieu of the stock exchanges' corporate governance standards. Whether a listed foreign private issuer follows the stock exchanges' corporate governance standards or its home-country practice, it must disclose any ways in which its corporate governance practices differ from those followed by domestic US companies.
- **Controlled companies.** As mentioned above, a controlled company is a company in which more than 50% of the voting power for the election of directors is held by an individual, a group, or another company. Master limited partnerships often qualify as controlled companies. A controlled company is not required to comply with the stock exchanges' requirements to have a majority of independent directors, a nominating/corporate governance committee, or a compensation committee. If a controlled company chooses to have a nominating/corporate governance committee or a compensation committee, the committees do not need to consist of independent directors.

Majority of independent directors

A majority of a company's board of directors must consist of independent directors. A director will qualify as independent only if the board affirmatively determines that the director does not have any material relationships with the company (either directly or as a partner, shareholder, or officer of an organization that has a relationship with the company). In making its determination, the board of directors must consider a candidate's

commercial, industrial, banking, consulting, legal, accounting, charitable, and familial relationships, among others. A director's stock ownership, even if significant, should not in and of itself negate a determination of independence.

A director would not be independent if:

- currently or during the previous three years, either the director was an employee of the company or an immediate family member of the director was an executive officer of the company;
- during any 12-month period within the last three years, the director (or any of the director's immediate family members) has received more than \$120,000 in direct compensation from the company (other than in the form of director and committee fees, pension, or other forms of deferred compensation for prior service, provided such compensation is not contingent in any way on continued service);
- (i) the director is a current partner or employee of a firm that is the company's internal or external auditor; (ii) the director has an immediate family member who is a current partner of such a firm; (iii) the director has an immediate family member who is a current employee of such a firm and personally works on the company's audit; or (iv) the director or an immediate family member was, within the last three years, a partner or employee of such a firm and personally worked on the company's audit within that time;
- the director or an immediate family member is, or has been within the last three years, employed as an executive officer of another company where any of the listed company's present executive officers at the same time serves or served on that company's compensation committee; or

- the director is a current employee, or an immediate family member is a current executive officer, of a company that has made payments to, or received payments from, the listed company for property or services in an amount which, in any of the last 3 fiscal years, exceeds the greater of \$1 million, or 2% of such other company's consolidated gross revenues.

An "immediate family member" is defined broadly to include a person's spouse, parents, children, and siblings, as well as mothers- and fathers-in-law, sons- and daughters-in-law, brothers- and sisters-in-law, and anyone who shares that person's home (other than a domestic employee). "Listed company" or "company," for the purpose of determining independence, includes any parent or subsidiary in a consolidated group with the company.

With respect to service on the compensation committee, the board of directors must affirmatively conclude that the director can be independent from management after considering all relevant factors, including:

- the director's compensation, including any consulting, advisory, or other compensatory fees paid by the listed company; and
- any affiliation between such director and the listed company, any of its subsidiaries, or any affiliates of its subsidiaries.

Executive sessions

The listed company must hold regularly scheduled meetings of non-management directors without management present. A listed company that chooses to include all non-management directors at such meetings should also hold an executive session solely for independent directors at least once a year.

Nominating/corporate governance committee

The listed company must have a fully independent nominating/corporate governance committee, which is governed by a written charter that:

- addresses the committee's purpose and responsibilities, which must include: identifying and selecting, or recommending director nominees; developing and recommending corporate governance principles; and overseeing the evaluation of the board and management; and
- provides for an annual performance evaluation of the committee.

The nominating/corporate governance committee charter should also address how the committee:

- qualifies its members;
- appoints and removes its members;
- is structured and operates (including the authority to delegate to subcommittees); and
- reports to the board.

Finally, the committee charter should also specify that the committee has the sole authority over the retention and termination of any company engaged to identify director candidates, including the terms and fees relating to such search.

Compensation committee

Companies must have a fully independent compensation committee, which is governed by a written charter that:

- addresses its purpose and responsibilities, including, at a minimum, direct responsibility for:
 - setting corporate goals and objectives relevant to chief executive

officer (CEO) compensation, evaluating CEO performance, and determining and approving CEO compensation levels in light of such evaluation;

- recommending compensation, incentive-compensation plans, and equity-based plans for non-CEO executives that are subject to approval of the board; and
- producing a report on executive compensation as required by the Securities and Exchange Commission (SEC) to be included in the company's annual proxy statement or annual report filed with the SEC;
- provides for an annual performance evaluation of the compensation committee; and
- sets forth the following rights and responsibilities with respect to the use of compensation consultants, legal counsel, or other advisers by the compensation committee:
 - the ability, in its sole discretion, to retain or obtain the advice of a compensation consultant, independent legal counsel, or other adviser upon considering all of the factors relevant to that person's independence from management, including:
 - any other services to be provided to the company by the employer of the compensation consultant, legal counsel, or other adviser;
 - any fees to be received from the company by the employer of the compensation consultant, legal counsel, or other adviser taken as a percentage of the total revenue of such employer;
 - the policies and procedures of the employer of the compensation consultant, legal counsel, or other adviser that are designed to prevent conflicts of interest;
 - any business or personal relationships between any member of the compensation committee and the proposed compensation consultant, legal counsel, or other adviser;
 - whether such compensation consultant, legal counsel, or other adviser owns any stock of the listed company;
 - 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 listed company; and
 - responsibility for the appointment, compensation, and oversight of the work of any such compensation consultant, independent legal counsel, or other adviser. The listed company must provide for appropriate funding, as determined by the compensation committee, for payment of reasonable compensation to such compensation consultant, independent legal counsel, or other adviser.

The compensation committee charter should also address committee member qualifications, committee member appointment and removal, committee structure and operations (including authority to delegate to subcommittees), and committee reporting to the board.

Audit committee

Composition

Companies must have an audit committee composed of at least three members that meet all of the stock exchange

independence requirements as well as the independence and other requirements of Exchange Act Rule 10A-3 (implementing Section 301 of Sarbanes–Oxley).

The audit committee members must be “financially literate,” and at least one member must have accounting or financial management expertise, as determined by the company’s board based on its business judgment. For any audit committee member that serves on the audit committees of more than three public companies at the same time, the board must determine that such service would not affect such member’s ability to serve effectively on its audit committee, and it must disclose its determination on or through the company’s website or in the company’s annual proxy statement or, if the company does not file an annual proxy statement, in its annual report filed with the SEC.

Charter

The audit committee must have a written charter that addresses:

- the committee’s purpose, which at a minimum must be to:
 - assist the board with oversight of (i) the integrity of the company’s financial statements; (ii) the company’s compliance with legal and regulatory requirements; (iii) the independent auditor’s qualifications and independence; and (iv) the performance of the company’s internal audit function and independent auditors; and
 - prepare an audit committee statement as required by the SEC to be included in the company’s annual proxy statement or annual report filed with the SEC;
- an annual performance evaluation of the audit committee; and
- the duties and responsibilities of the audit committee, which at a minimum must include those set out in Exchange Act Rule 10A-3(b)(2), (3), (4), and (5) (concerning responsibilities relating to: (i) registered public accounting firms; (ii) complaints relating to accounting, internal accounting controls, or auditing matters; (iii) authority to engage advisers; and (iv) funding as determined by the audit committee), as well as to:
 - at least annually, obtain and review a report by the independent auditor describing: (i) the firm’s internal quality-control procedures; (ii) any material issues raised by the most recent internal quality-control review, or peer review, of the firm, or by any inquiry or investigation by government or professional bodies, within the preceding five years respecting one or more independent audits carried out by the firm, and any steps taken to deal with any such issues; and (iii) all relationships between the independent auditor and the company (to assess the auditor’s independence);
 - meet to review and discuss the company’s annual audited financial statements; quarterly unaudited financial statements with management and the independent auditor, including the company’s management, discussion, and analysis disclosures; earnings press releases; financial information and earnings guidance provided to analysts and rating agencies; and policies with respect to risk assessment and risk management;
 - meet separately, periodically, with management, with internal auditors and with independent auditors;
 - review with the independent auditors any audit problems or difficulties and management’s response;

- set clear hiring policies for employees or former employees of the independent auditors; and
- report regularly to the board.

Listed company audit committees— Rule 10A-3

Exchange Act Rule 10A-3 (which implements Section 301 of Sarbanes–Oxley) requires that each audit committee member has to be a member of the board of directors and meet certain independence requirements. To be “independent,” an audit committee member is barred from accepting any compensatory fees from the company or any subsidiary, other than in their capacity as a member of the board, and may not be an “affiliated person” of the company. The definition of affiliated person includes a person who, directly (or indirectly through one or more intermediaries) controls, or is controlled by, or is under common control with the specified person. However, a safe harbor exists for certain non-executive officers and other persons who hold shares of 10% or less of the company.

Rule 10A-3 also requires that:

- the audit committee must be “directly responsible” for the appointment, compensation, oversight, and retention of the external auditors, who must report directly to the audit committee;
- the audit committee must establish procedures for the receipt, retention, and treatment of complaints regarding accounting, internal controls, or auditing matters, and the confidential, anonymous submission by employees of concerns regarding questionable accounting or auditing matters;
- the audit committee must have the authority to engage independent counsel and other advisers as it deems necessary to carry out its duties; and

- the company must provide the audit committee with appropriate funding for payment of external auditors, advisers employed by the audit committee, and ordinary administrative expenses of the audit committee.

Under the stock exchange rules, IPO companies are entitled to certain exemptions during a transitional period following their public offering:

- **For the first 90 days** from the date of listing, all but one of the members of the audit committee may be exempt from the independence requirements.
- **For the first year** after the date of listing, a minority of the members of the audit committee are exempt from the independence requirement (e.g. only two out of three members need to be independent for days 91 through 365).

These transitional rules effectively apply in the same manner to EGCs, controlled companies, and all other IPO companies.

An IPO company will have to disclose in any proxy or information statement filed with the SEC and in its annual report that it has relied on one of these exemptions and the company’s assessment of whether and, if so, how, such reliance on an exemption would materially adversely affect the ability of the audit committee to act independently.

Audit committee financial expert

Sarbanes–Oxley requires that at least one member of a public company’s audit committee has accounting or financial management expertise that would qualify that person as an audit committee financial expert. The SEC defines an audit committee financial expert as someone who has: (i) education and experience as a public accountant, auditor, principal financial officer, principal accounting officer, or

controller, or experience in one or more positions that involve performance of similar functions; (ii) experience actively supervising persons in the positions above; (iii) experience overseeing or assessing the performance of companies or public accountants with respect to the preparation, auditing, or evaluation of financial statements; or (iv) other relevant experience, and who has:

- an understanding of GAAP and financial statements;
- the ability to assess the general application of such principles in connection with the accounting for estimates, accruals, and reserves;
- experience preparing, auditing, analyzing, or evaluating financial statements that present a breadth and level of complexity of accounting issues that are generally comparable to the breadth and complexity of issues that can reasonably be expected to be raised by the company's financial statements, or experience actively supervising one or more persons engaged in such activities;
- an understanding of internal controls and procedures for financial reporting; and
- an understanding of audit committee functions.

A public company must disclose in its Form 10-K the name of at least one audit committee financial expert on the company's audit committee or, if no audit committee financial expert sits on

the audit committee, an explanation of why the committee does not include a financial expert.

Corporate governance requirements for foreign private issuers

As noted above, foreign private issuers are permitted to follow home-country practice in lieu of the stock exchanges' corporate governance standards, other than the requirements that they must: (i) have an audit committee that meets the requirements of Exchange Act Rule 10A-3; and (ii) provide prompt notification from its CEO of non-compliance with the applicable provisions of the governance rules.

Whether a listed foreign private issuer follows the corporate governance standards or its home-country practice, it must disclose any ways in which its corporate governance practices differ from those followed by domestic US companies. A brief, general summary of differences is enough. A foreign private issuer that is required to file an annual report on Form 20-F with the SEC must include the statement of significant differences in that annual report. All other foreign private issuers may either (i) include the statement of significant differences in an annual report filed with the SEC, or (ii) make the statement of significant differences available on or through the listed company's website. If the statement of significant differences is made available on or through the listed company's website, the listed company must disclose that fact in its annual report filed with the SEC and provide the website address.

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