

## SEC Adopts Compensation Committee Listing Standards and Compensation Consultant Disclosure Rules

On June 20, 2012, the U.S. Securities and Exchange Commission (SEC) adopted “Listing Standards for Compensation Committees,”<sup>1</sup> implementing Section 952 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Dodd-Frank Act), which added Section 10C to the Securities Exchange Act of 1934 (Exchange Act).

Section 10C required the SEC to adopt rules directing the national securities exchanges to prohibit the listing of equity securities of any issuer not in compliance with the compensation committee independence requirements and the compensation adviser requirements set forth in the Dodd-Frank Act, and to adopt disclosure rules concerning compensation consultant conflicts of interest. The SEC initially proposed compensation committee and compensation consultant rules in March 2011.<sup>2</sup>

Although containing a few changes from the proposed rules, the final rules closely mirror the statutory language of the Dodd-Frank Act, giving discretion to the exchanges to provide additional detail, restrictions and exemptions, subject to the SEC’s approval of any proposed listing standards.

### Independence

The SEC has adopted new Rule 10C-1 under the Exchange Act to implement the Dodd-Frank Act requirement for listing standards relating to compensation committees. Tracking the statutory language of the Dodd-Frank Act, Rule 10C-1 requires the exchanges to consider relevant factors when determining independence requirements for

compensation committee members, including, but not limited to:

- The source of a board member’s compensation, including any consulting, advisory or other compensatory fee paid by the issuer to such board member; and
- Whether a board member is affiliated with the issuer, a subsidiary of the issuer or an affiliate of a subsidiary of the issuer.

Rule 10C-1 does not establish any safe harbors for particular relationships or identify any relationships that would bar an independence determination.

While the Dodd-Frank Act requires that all members of a compensation committee be directors and be independent, neither Section 10C of the Exchange Act nor new Rule 10C-1 defines “independence.” Rather than imposing a uniform definition, Rule 10C-1 leaves discretion to each exchange to develop its own independence standards. As with all exchange rules, such independence standards must be approved by the SEC.

Unlike the mandatory requirements of Rule 10A-3, which provide for enhanced independence standards for audit committee members, Rule 10C-1 only requires the exchanges to consider relevant factors, including the two specified above, when developing compensation committee independence standards. The exchanges are not required to preclude compensation committee membership where relationships described in the relevant

factors exist. For example, the exchanges will not be required to prohibit directors who represent holders of a large percentage of a company's shares from serving on compensation committees, although such significant investors may be affiliates of the company by virtue of their share holdings.

The SEC left it to the exchanges to determine the details of compensation committee listing standards not expressly mandated by the Dodd-Frank Act. In so doing, however, the SEC is requiring the exchanges to provide information to the SEC beyond what is typically required when the exchanges submit rule changes. For example, in addition to setting forth its proposed definition of independence, the exchange will have to review whether and how its proposed or existing listing standards satisfy the requirements of Rule 10C-1, and describe how the exchange considered factors relevant to compensation committee independence.

Rule 10C-1 addresses only current relationships between the issuer and the compensation committee member and does not mandate a "look-back" period for the required factors. However, look-backs could be added by an exchange when proposing its listing standards.

Listing standards to be adopted under Rule 10C-1 must provide procedures that give listed companies the opportunity to cure defects. Rule 10C-1 expressly allows listing standards to provide that if a compensation committee member ceases to be independent for reasons outside of such director's reasonable control, the director will be permitted to remain a compensation committee member until the earlier of the company's next annual meeting or one year from the event that caused the member to no longer be independent. The listed company would be required to notify its exchange if it makes use of such rule.

Neither the Dodd-Frank Act nor Rule 10C-1 requires any company to have a compensation committee. That requirement arises from applicable stock exchange listing standards, if any. However, Rule 10C-1 requires that compensation

committee listing standards apply to any committee that oversees executive compensation, even if such committee performs multiple functions and is not formally designated as a "compensation committee."

For companies that do not have a compensation committee, or other formal committee that oversees executive compensation, final Rule 10C-1 requires that the listing standards adopted by the exchanges apply the compensation committee independence requirements, including the requirements relating to consideration of a compensation adviser's independence and responsibility for appointment and oversight of compensation advisers, to the members of a listed company's board of directors who, in the absence of such a formal committee, oversee executive compensation matters. As a result, there will be little substantive difference in the application of Rule 10C-1 to public companies that have compensation committees and those that do not.

## Compensation Advisers

Like the Dodd-Frank Act, Rule 10C-1 provides that the compensation committee of a listed issuer may, in its sole discretion, retain or obtain the advice of a compensation consultant, an independent legal counsel or some other adviser. The compensation committee is directly responsible for the appointment, compensation and oversight of such advisers. However, the compensation committee is not required to implement the recommendations of any such adviser, and the committee may exercise its own judgment in the fulfillment of its duties. The issuer must provide appropriate funding for such advisers, as determined by the compensation committee.

Under Rule 10C-1, a compensation committee may select such compensation consultant, legal counsel or other adviser only after taking into consideration the following factors, as well as any other factors identified by the relevant exchange in its listing standards:

- The provision of other services to the issuer by the person that employs the compensation consultant, legal counsel or other adviser;
- The amount of fees received from the issuer 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 compensation 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 issuer 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 issuer.

This last factor was not included in the rule as originally proposed by the SEC in 2011. This provision requires the compensation committee to consider, for example, whether an executive officer of the issuer has a familial relationship or a business partnership with a compensation consultant.

Compensation committees must consider these six factors in their totality. No single factor is determinative and a compensation committee may select any compensation adviser it prefers, even if any of these factors exist, as long as the committee considers them all. There are no thresholds associated with the six factors required to be considered. Therefore, the compensation committee must take all facts and circumstances into account. However, the compensation committee does not have to consider any of these factors before consulting in-house counsel. Furthermore, the SEC emphasized that there is no

requirement that a compensation adviser be independent, only that the compensation committee consider these factors before selecting a compensation adviser.

## Exemptions

Rule 10C-1, like the corresponding Dodd-Frank Act provision, exempts the following issuers from the compensation committee independence requirements:

- Limited partnerships;
- Companies in bankruptcy proceedings;
- Open-end management investment companies registered under the Investment Company Act of 1940; and
- Any foreign private issuer that discloses in its annual report the reasons that the foreign private issuer does not have an independent compensation committee.

Rule 10C-1 exempts controlled companies and smaller reporting companies from all of the requirements of the new compensation committee independence requirements and authorizes the exchanges to exempt other categories of issuers, in each case subject to SEC review and approval. Rule 10C-1 also exempts listed security futures products and listed standardized options from its requirements.

## Compensation Consultant Disclosure and Conflicts of Interest

The compensation consultant disclosure and conflict of interest requirements of the Dodd-Frank Act were implemented by the SEC by retaining its existing disclosure requirements related to compensation consultants set forth in Item 407(e)(3)(iii) of Regulation S-K and adding a new subsection (iv) to Item 407(e)(3). This approach represents a departure from the SEC's proposed rules, which would have integrated the existing compensation consultant disclosure requirements with the new conflict of interest disclosure requirement.

Existing Item 407(e)(3)(iii) requires companies to disclose the role of compensation consultants in determining or recommending the amount or form of executive and director compensation. Companies must identify the consultants, state who retained the consultants, describe the nature and scope of the assignment and, in certain circumstances, disclose the aggregate fees paid to the consultants.

If any compensation consultants whose work must be disclosed pursuant to existing Item 407(e)(3)(iii) have a conflict of interest, new Item 407(e)(3)(iv) requires disclosure of the nature of such conflict and how the conflict is being addressed, regardless of whether the compensation committee, management or any other board committee retained the consultant. In determining whether a conflict of interest exists for disclosure purposes, companies should consider the same factors that the Dodd-Frank Act and Rule 10C-1 require compensation committees to consider when hiring compensation consultants.

To the extent that consulting on director compensation raises a conflict of interest on the part of a compensation consultant, disclosure regarding such conflict would be required by the new rules. Item 407(e)(3)(iv) does not require disclosure of potential conflicts of interest or an appearance of conflict of interest; disclosure is required only for actual conflicts of interest of a compensation consultant. Consulting on broad-based plans and providing non-customized benchmark data will not require conflicts of interest disclosure under this new rule. Finally, Item 407(e)(3)(iv) does not require disclosure with respect to compensation advisers other than consultants.

The new compensation consultant disclosure requirement will apply to all issuers subject to the SEC's proxy rules, including controlled companies, non-listed issuers and smaller reporting companies. Disclosure will be required in proxy or information statements for annual meetings (or special meetings in lieu of annual meetings) at which directors are elected.

## Timing

The final rules are effective July 27, 2012. Each national securities exchange has until September 25, 2012 to submit proposed listing standards to the SEC for approval. The exchanges must have final listing standards regarding the independence requirements for compensation committee members that comply with the SEC's final rule not later than June 27, 2013. Issuers must comply with the new disclosure rules described above regarding compensation consultant conflicts of interest as set forth in Item 407 of Regulation S-K for any proxy statement or information statement filed in relation to an annual meeting (or special meeting in lieu of annual meeting) at which directors will be elected occurring on or after January 1, 2013.

## Practical Considerations

- Companies should brief their boards of directors, and particularly their compensation and governance committees, on the SEC's final rules on compensation committees and compensation consultant disclosure, and the changes to listing standards that will follow.
- Since the ultimate detail that goes beyond that specified in the Dodd-Frank Act will be contained in the applicable exchange listing standards, it will be important for companies to review the proposed listing standards that their exchanges will file with the SEC to determine if the proposed standards would require any changes to compensation committee composition. In order to implement transitions at a time that is convenient to the compensation committee's deliberation process, some companies might want to consider proposed listing standards when next reviewing committee assignments. However, it is not necessary to make changes to compensation committee composition until the final rules are in place.
- Companies may want to use the time before the 2013 proxy season to discuss with their compensation consultants how they identify and handle conflicts issues, and to consider

whether any compensation consultant conflict of interest disclosure will be needed in their 2013 proxy statements.

- When preparing director and officer questionnaires, companies should consider adding a question to determine if their executive officers or directors have any business or personal relationships with a compensation consultant or other compensation adviser retained or proposed to be retained by the company or the compensation committee.
- Companies should consider whether their compensation committee charters need to be amended (either now or after the applicable exchange has finalized its new listing standards) to reflect the independence considerations. Also, it might be wise to amend the compensation committee charter to expressly grant authority for the compensation committee to retain compensation consultants and to provided funding for this purpose, to the extent such matters are not already addressed in the charter.

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*If you have any questions regarding the compensation committee listing standards and compensation consultant disclosure rules, please contact the author of this Legal Update, **Laura D. Richman**, at +1 312 701 7304, or any of the lawyers listed below or any other member of either our Corporate & Securities group or our Employment & Benefits group.*

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## Endnotes

- 1 Release Nos. 33-9330; 34-67220, *available at* <http://www.sec.gov/rules/final.shtml>.
- 2 Release Nos. 33-9199; 34-64149, *available at* <http://www.sec.gov/rules/proposed/proposedarchive/proposed2011.shtml>

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