

## Corporate Alert

### SEC Adopts Rules Requiring Listing Standards for Compensation Committees and Compensation Advisors

June 27, 2012

On June 20, 2012, the Securities and Exchange Commission (SEC) adopted final rules that require the national securities exchanges to adopt new listing standards regarding compensation committees and compensation advisors. The new rules are in response to a provision in the Dodd-Frank Wall Street Reform and Consumer Protection Act that added a new Section 10C to the Securities Exchange Act of 1934. Section 10C requires the SEC to adopt rules directing the exchanges to prohibit the listing of equity securities of an issuer not in compliance with the compensation committee and compensation advisor requirements of such statute. The final rules also amend Item 407 of Regulation S-K to require additional disclosure relating to compensation consultants and conflicts of interest.

The exchanges will have 90 days after publication of the final rules in the *Federal Register* to propose their listing standards, which will then be subject to approval by the SEC. The exchanges will need to have final listing standards in place within one year after the SEC's final rules are published in the *Federal Register*. The new Item 407 disclosure will be required in any proxy or information statement for an annual shareholder meeting (or a special meeting in lieu of the annual meeting) at which directors will be elected occurring on or after January 1, 2013.

#### Compensation Committee Member Independence

*Overview.* The SEC's final rules, which are set forth in new Rule 10C-1 of the Exchange Act, direct the exchanges to adopt listing standards that require each member of a compensation committee<sup>1</sup> to be (i) a member of the board of directors and (ii) independent. While the rules do not define "independence," they list certain relevant factors from Section 10C(a)(3) for the exchanges to consider in their determination of a definition, in particular:

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

This approach is more flexible than the independence requirements for audit committee members under the Sarbanes-Oxley Act of 2002, set forth in Section 10A(m) of the Exchange Act, which prohibit audit committee members from

<sup>1</sup> The final rules define compensation committee to mean (i) a board committee designated as a compensation committee; (ii) in the absence of such board committee, a board committee performing similar functions of a compensation committee, including oversight of executive compensation; and (iii) for purposes other than the listing standards relating to the committee's authority to retain compensation advisors and requiring the company to provide funding for such advisors, members of the board who oversee executive compensation matters on behalf of the board. The New York Stock Exchange requires listed issuers to have compensation committees, but Nasdaq allows executive compensation to be determined (or recommended to the board) either by an independent committee or by a majority of the board's independent directors by separate vote.



receiving any consulting, advisory or other compensatory fee from the issuer (other than as a member of the audit committee) or from being an affiliate of the issuer or any subsidiary of the issuer. Consequently, the final rules do not contain a safe harbor for affiliate status. In the adopting release, the SEC explained that the exchanges may determine that, even though affiliated directors are not allowed to serve on audit committees, it may be appropriate that representatives of significant shareholders be permitted to serve on compensation committees, as some commentators had noted that the interests of major shareholders are generally aligned with those of other shareholders with respect to executive compensation. The SEC emphasized, however, that it is important for exchanges to consider other ties between an issuer and a director, in addition to share ownership, that might impact the director's judgment as a member of the compensation committee. Because the SEC has provided the exchanges with discretion to determine the ultimate independence standards, the impact of the final rules will largely depend on the listing standards yet to be adopted by the exchanges.

*Exemptions.* The final rules exempt the following categories of companies from these compensation committee member independence requirements:

- controlled companies (i.e., companies in which more than 50 percent of the voting power in the election of directors is held by an individual, a group or another company)
- smaller reporting companies (i.e., in general, issuers with a public float of less than \$75 million)
- limited partnerships
- companies in bankruptcy proceedings
- open-end management investment companies registered under the Investment Company Act of 1940
- foreign private issuers that disclose in their annual reports the reasons they do not have an independent compensation committee.

In addition, the final rules allow the exchanges to exempt (i) a particular relationship from the compensation committee member independence requirements, as appropriate, taking into consideration the size of the issuer and any other relevant factors, and (ii) any category of company, as appropriate, from all of the requirements of the new compensation committee listing standards.

*Opportunity to Cure.* The final rules direct the exchanges to prohibit the listing of any equity security of an issuer not in compliance with these independence requirements, as required by the statute. Nevertheless, as required by Section 10C, issuers must have a reasonable opportunity to cure any defects that would result in the delisting or prohibition of the listing of such issuer's securities because of the failure to meet the new requirements. Therefore, an exchange may allow a compensation committee member who ceases to be independent for reasons outside such member's reasonable control to remain a member until the earlier of the next annual meeting or one year from the occurrence of the event that caused the member to be no longer independent, with notice to the applicable exchange by the issuer.

## **Compensation Committee Authority to Retain, and Responsibility Regarding, Compensation Advisors**

*Overview.* In the final rules, the SEC also directs the exchanges to adopt listing standards regarding the authority of compensation committees to retain compensation consultants, independent legal counsel and other advisors (collectively, "compensation advisors"), as well as such compensation committees' responsibilities regarding such compensation advisors. Specifically, the exchanges must adopt listing standards requiring issuers to comply with the following requirements regarding compensation committees:

- The committee must have the authority, in its sole discretion, to retain or obtain the advice of compensation advisors.
- The committee must be directly responsible for the appointment, compensation and oversight of the work of any compensation advisor.
- Each listed issuer must provide appropriate funding for the payment of reasonable compensation, as determined by the committee, to compensation advisors.
- Before selecting any compensation advisor, the committee must take into consideration the six specific factors identified by the SEC as set forth below, as well as any other factors identified by the exchanges that affect the independence of compensation advisors.

The final rules do not require compensation advisors to be independent. They do, however, require compensation committees to consider, at a minimum, the following independence factors, as well as any other factors identified by the exchanges, before selecting a compensation advisor:

- whether the person who employs the compensation advisor is providing any other services to the issuer
- how much the person who employs the compensation advisor has received in fees from the issuer, as a percentage of that person's total revenue
- which policies and procedures that are designed to prevent conflicts of interest have been adopted by the person employing the compensation advisor
- whether the compensation advisor has any business or personal relationship with a member of the compensation committee
- whether the compensation advisor owns any stock of the issuer
- whether the compensation advisor or the person employing the advisor has any business or personal relationship with an executive officer of the issuer.

The SEC acknowledged that these independence factors should be considered in their totality and that no one factor alone should be viewed as a determinative factor of independence. The SEC declined to impose any bright-line cutoff or materiality thresholds to determine independence, but allows the exchanges to identify other factors for compensation committees to consider. The SEC also clarified that compensation committees are required to conduct the independence assessment prior to receiving advice from any compensation advisor, other than in-house counsel. To comply with these listing standards, the SEC noted that compensation committees will likely need to create procedures for collecting and analyzing information about potential compensation advisors before they can receive advice from such advisors.

*Exemptions.* The final rules exempt controlled companies and smaller reporting companies from all of the requirements of the new compensation committee listing standards, including those related to the committee's authority to retain, and responsibility regarding, compensation advisors. As mentioned above, the final rules also allow the exchanges to exempt any category of company, as appropriate, from all of the requirements of the new compensation committee listing standards. As such, the exchanges may consider whether these new listing standards should apply to the new category of issuer, emerging growth companies, established under the Jumpstart Our Business Startups Act.

## **Disclosure Regarding Compensation Consultants and Conflicts of Interest**

*Overview.* Finally, pursuant to the final rules, issuers will have to expand their disclosure regarding compensation consultants. Currently, Item 407(e)(3) of Regulation S-K requires registrants that are subject to the proxy rules to

provide certain disclosure regarding their compensation committees and the use of compensation consultants, including details about the fees paid to compensation consultants. The new rules include an additional disclosure requirement that companies disclose, with regard to a compensation consultant whose work has raised any conflict of interest, the nature of the conflict and how the conflict is being addressed.

While the SEC has not defined “conflict of interest,” the rule advises companies to consider the same six independence factors discussed above in determining whether there is a conflict of interest. Nevertheless, issuers will also need to consider the specific facts and circumstances and may consider other factors in their determinations of whether a consultant’s engagement may present a conflict of interest that needs to be disclosed. If the committee determines that a conflict of interest exists, it will need to include a concise and clear description of both the conflict and the manner in which it was addressed, not merely a description of the issuer’s general policies and procedures on resolving conflicts.

*Application.* These disclosure requirements will apply to Exchange Act registrants subject to the SEC’s proxy rules, including controlled companies, nonlisted issuers and smaller reporting companies. The current exception under Item 407 relating to compensation consultants who only consult with the compensation committee on broad-based plans or provide noncustomized benchmark data will also apply to the new conflicts of interest disclosure.

## Conclusion

The SEC’s adoption of these final rules does not require significant action by issuers at this time because a majority of the final rules direct the exchanges to adopt new listing standards and the new disclosure requirement relating to compensation advisor conflicts of interest will not apply until the 2013 proxy season. Nevertheless, companies should begin to consider how these rules and new listing standards may impact them. Specifically, for the 2013 proxy season, compensation committees will need to create procedures for collecting and analyzing information relating to compensation advisors so they can determine the independence of such advisors and whether any conflicts of interest exist. In addition, as the new listing standards are proposed and adopted, companies will need to evaluate the independence of their compensation committee members based on the new listing standards and update their director and officer questionnaires to ensure they are collecting the necessary information for such evaluation. Companies will also need to revise their compensation committee charters as necessary to ensure the compensation committee has the requisite authority and responsibilities, as well as company funding, relating to compensation advisors.

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