

securities lawflash

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SEC Adopts Compensation Committee and Adviser Independence Rules

New rules address compensation committee member and adviser independence and disclosure requirements for compensation consultant conflicts of interest.

On June 20, the Securities and Exchange Commission (SEC) adopted final rules directing national securities exchanges and national securities associations (collectively, the exchanges) to establish listing standards addressing the independence of compensation committee members; the committee's authority to retain Compensation Advisers (as defined below); and the committee's responsibility for the appointment, compensation, and oversight of its advisers. The final rules implement Section 952 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Dodd-Frank Act), which added Section 10C of the Securities Exchange Act of 1934, as amended (the Exchange Act), and which requires the SEC to adopt rules directing the exchanges to prohibit the listing of any equity security of an issuer that is not in compliance with Section 10C's compensation committee and Compensation Adviser requirements. The final rules also amend Item 407 of Regulation S-K to require companies to provide additional disclosures in their proxy statements on conflicts of interest of compensation consultants.

Under the final rules, the exchanges are required to propose new listing standards by September 25, 2012, and must have final rules or amendments that comply with Rule 10C-1 of the Exchange Act by June 27, 2013. Companies must provide new disclosures on conflicts of interest of compensation consultants in any proxy or information statement for an annual or special meeting of stockholders at which directors will be elected occurring on or after January 1, 2013.

Compensation Committee Independence Requirements

New Rule 10C-1 of the Exchange Act directs the exchanges to adopt new listing standards requiring a compensation committee to be composed solely of independent members of the board of directors, and requires the exchanges to establish new independence criteria for these members. While the final rules do not require a company to have a compensation committee, the new independence criteria, as well as the requirements relating to the consideration of a Compensation Adviser's independence and requirements relating to the responsibility for the appointment, compensation, and oversight of Compensation Advisers, are equally applicable to any board committee performing the functions typically performed by a compensation committee. In formulating the new independence standards, the exchanges are instructed to consider relevant factors, which must include the following:

- The sources of compensation, including consulting, advisory, or other fees paid by the issuer to such member of the board of directors.
- Whether the board member is affiliated with the company, any subsidiary of the company, or an affiliate of a subsidiary of the issuer.

The exchanges may consider additional relevant criteria, such as share ownership or business relationships with the issuer. The SEC emphasizes that the exchanges are provided with the flexibility to develop their own independence standards consistent with the nature and types of listed companies. In this regard, the SEC notes

that it may not be appropriate to prohibit directors affiliated with large stockholders, such as private equity funds and venture capital firms, from serving on a compensation committee. The SEC recognizes that directors elected by certain funds may have a strong institutional belief in the importance of appropriately structured and reasonable compensation arrangements and that their significant equity ownership may align the directors' interests with public stockholders on matters of executive compensation.

The final rules also reiterate an important distinction between the compensation committee independence requirements under Section 952 of the Dodd-Frank Act and the existing independence requirements for audit committee members under Rule 10A-3 of the Exchange Act. While the audit committee independence rules prohibit a director from serving on the audit committee if such director accepts consulting or advisory fees or is otherwise affiliated with the listed company or any of its subsidiaries, the Dodd-Frank Act does not require any mandatory exclusion of compensation committee membership due to these factors. Instead, the final rules only require that these two factors be considered in determining the independence of compensation committee members.

Exemptions from Independence Standards

The following categories of listed issuers are not subject to the independence standards described above:

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

The exchanges may exempt from the independence requirements a particular relationship with respect to members of the compensation committee as each exchange may determine, taking into consideration the size of an issuer and any other relevant factors.

Compensation Adviser Requirements

Authority and Oversight

The final rules require the exchanges to adopt listing standards providing the compensation committee with full discretion and authority to retain and obtain the advice of compensation consultants, independent legal counsel, and other advisers (collectively, Compensation Advisers). The compensation committee will be directly responsible for the appointment, compensation, and oversight of Compensation Advisers, and listed companies must provide appropriate funding to the compensation committee to retain these advisers. The final rules also make clear that the compensation committee is not required to obtain the advice or recommendation of any independent Compensation Adviser or to follow its advice.

Assessment of Compensation Adviser Independence

While the compensation committee is not required to retain any independent Compensation Adviser, the compensation committee is required to assess the independence of each Compensation Adviser prior to the Compensation Adviser being retained and to consider the following six factors (as well as any other factors identified by the relevant exchange):

- Whether the employer of the Compensation Adviser is providing any other services to the issuer
- The amount of fees received from the issuer by the employer of the Compensation Adviser as a percentage of such employer's total revenue

- Policies and procedures that have been adopted by the employer of the Compensation Adviser to prevent conflicts of interest
- Any business or personal relationship of the Compensation Adviser with a member of the compensation committee
- Any stock of the issuer owned by the Compensation Adviser
- Any business or personal relationship of the Compensation Adviser or employer of the Compensation Adviser with an executive officer of the issuer

The final rules clarify that these six factors should be considered as a whole, and no one factor is determinative or controlling. This list is not exhaustive, and the exchanges may consider other relevant factors in determining the independence assessment requirement.

The final rules also state that a listed issuer's compensation committee is required to conduct the independence assessment outlined above with respect to any Compensation Adviser that provides advice to the compensation committee, other than in-house legal counsel.

General Exemptions

The requirements relating to both the independence of compensation committees and the independence of Compensation Advisers shall not apply to the following categories of issuers:

- Controlled companies (companies where more than 50% of the voting power for the election of directors is held by an individual, a group, or another entity)
- Smaller reporting companies

The exchanges may also choose to exempt from the above-described requirements any further categories of issuers the exchanges determine appropriate.

In addition, the rules adopted by the exchanges must provide for appropriate procedures for a listed issuer to have a reasonable opportunity to cure any defects that would be a prohibition for listing. Such rules may provide that if a member of a compensation committee ceases to be independent in accordance with the requirements of Rule 10C-1 of the Exchange Act for reasons outside the member's reasonable control, that person, with notice by the issuer to the applicable exchange, may remain a compensation committee member of the listed issuer until the earlier of (i) the date of the next annual stockholder meeting of the listed issuer or (ii) one year from the occurrence of the event that caused the member to be no longer independent.

Conflicts of Interest Disclosures

The final rules amend Item 407(e) of Regulation S-K to expand the current proxy disclosure requirements regarding compensation consultants identified by listed issuers in their SEC disclosures, pursuant to Item 407(e)(3)(iii) of Regulation S-K, as having played a role in determining or recommending the amount or form of executive or director compensation. The final rules will require additional disclosures on (i) whether the work of a compensation consultant raised any conflict or interest, and (ii) if so, the nature of such conflict and how the conflict is being addressed. The new disclosure requirement applies only to conflicts of interest with respect to a compensation consultant, not to outside legal counsel or other advisers.

The final rules do not provide any definition of "conflicts of interest," and companies should consider their specific facts and circumstances in making such a determination. However, the final rules instruct companies to consider the same six factors described above relating to the independence of Compensation Advisers in analyzing whether conflicts of interest exist.

The new disclosure requirements will be applicable to all reporting companies subject to the proxy rules,

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regardless of whether the company is listed on an exchange. Accordingly, smaller reporting companies and controlled companies will also be required to provide the additional disclosures, although foreign private issuers will be exempt from such requirements.

Practical Considerations

Assessment of compensation committee composition: While the new compensation committee independence requirements may not become effective until after the 2013 proxy season, companies should begin analyzing the composition of the compensation committee to determine whether the independence of any director may be affected by the new listing standards.

Review of the compensation committee charter and director and officer questionnaire: The new listing standards are likely to require companies to review and update compensation committee charters and director and officer questionnaires to reflect the new independence criteria for directors.

Analysis of Compensation Adviser independence and conflicts of interest: Given that new factors must be considered in determining the independence of Compensation Advisers, companies and compensation committees should be proactive in establishing or updating procedures for collecting the information necessary to conduct the required independence and conflicts of interest analysis. This may include new screening questionnaires for Compensation Advisers, additional interview sessions, and committee meetings to discuss independence and potential conflicts of interest. The collection of such information should be part of an enhanced disclosure and control procedure designed to ensure that companies can prepare and determine, in a timely manner, whether there are independence questions warranting further discussion regarding Compensation Advisers and if there will be conflicts of interest disclosures relating to compensation consultants in their proxy statements.

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