

# Client Alert

July 2012

## SEC Adopts Final Rules Related to Compensation Committees and Compensation Advisers; National Securities Exchanges Must Now Promulgate New Listing Standards

On June 20, 2012, the Securities and Exchange Commission (the "SEC") adopted final rules implementing Section 10C of the Securities Exchange Act of 1934 (the "Exchange Act"), which was added by Section 952 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the "Dodd-Frank Act"). The SEC's final rules are available [here](#). The rules (i) add Exchange Act Rule 10C-1 directing the national securities exchanges to adopt listing standards mandating the independence of compensation committee members; the authority of compensation committees to hire their own compensation consultants, independent legal counsel and other advisers (collectively, "compensation advisers"); and certain factors to be considered by the compensation committee before selecting a compensation adviser and (ii) amend Item 407 of Regulation S-K to require issuers to disclose conflicts of interest raised by the work of their compensation consultants.<sup>1</sup>

### Compensation Committee Listing Standards

Rule 10C-1 requires national securities exchanges, including the New York Stock Exchange and NASDAQ, to adopt listing standards mandating the following:

***Independence of Compensation Committee Members.*** Each member of an issuer's compensation committee<sup>2</sup> must be a member of the issuer's board of directors and must be "independent." The term "independent" is not specifically defined in Section 952 of the Dodd-Frank Act or the SEC's final rules. In defining "independent," the national securities exchanges are directed to consider "relevant factors," including the following:

- the source of compensation of a member of the board of directors, including any consulting, advisory or other compensatory fee paid by the issuer to such director; and

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<sup>1</sup> The process for implementing the new compensation committee rules under Section 952 of the Dodd-Frank Act is similar to that followed in connection with the implementation of the corporate governance provisions of the Sarbanes-Oxley Act of 2002 (the "Sarbanes-Oxley Act"). In each case, the applicable act required the SEC to direct the national securities exchanges to adopt certain listing standards and prohibit the initial listing or continued listing of issuers, subject to certain exceptions, if such issuers fail to comply with the listing standards.

<sup>2</sup> The new rules define "compensation committee" to mean: (i) a board committee that is designated as the compensation committee; (ii) in the absence of a board committee designated as the compensation committee, a board committee that performs functions typically performed by a compensation committee, including oversight of executive compensation, even if it is not designated as the compensation committee or also performs other functions; or (iii) for all purposes other than the new listing standards related to the authority to retain compensation advisers and required funding for the payment of such advisers, the members of the board who oversee executive compensation matters on behalf of the board.

- whether a member of the board of directors of an issuer is affiliated with the issuer, a subsidiary of the issuer or an affiliate of a subsidiary of the issuer.

The SEC's final rules permit a national securities exchange to exempt a particular relationship from the definition of "independent," taking into consideration the size of the issuer and any other relevant factors. As with all the rules to be promulgated by the national securities exchanges, any exemption, however, would be subject to SEC approval.<sup>3</sup>

**Authority to Retain Compensation Advisers.** Although a compensation committee is not required to hire its own compensation adviser, a compensation committee must have the authority, in its sole discretion, to retain or obtain the advice of a compensation adviser. Additionally, the compensation committee (not management) must be directly responsible for compensating and overseeing the work of the compensation adviser retained by the compensation committee. Finally, the issuer must appropriately fund the compensation committee so it can pay the reasonable fees (as determined by the compensation committee) of any compensation adviser retained by the compensation committee.<sup>4</sup>

**Selection of Compensation Adviser.** The SEC's final rules do not require that any compensation adviser engaged by a compensation committee be independent or prevent the compensation committee from retaining or obtaining advice from nonindependent compensation advisers, including any compensation adviser engaged by management. However, under the SEC's final rules, a compensation committee may select a compensation adviser only after considering the following six factors:

- the provision of other services to the issuer by the firm that employs the compensation adviser;
- the amount of fees received by the firm that employs the compensation adviser, as a percentage of that person's total revenue;
- the policies and procedures of the firm that employs the compensation adviser that are designed 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; and
- any business or personal relationship of the compensation adviser or the person employing the adviser with an executive officer of the issuer.

The SEC's final rules permit the national securities exchanges to include other factors to be considered by compensation committees in their listing standards. The final rules also clarify that the independence factors listed above do not need to be considered by the compensation committee prior to consulting with or obtaining advice from in-house legal counsel.

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<sup>3</sup> Although the national securities exchanges have been given discretion in defining independence for compensation committee members, given the similar statutory language and policy objectives of the corporate governance-related provisions of the Sarbanes-Oxley Act applicable to audit committee members and the Dodd-Frank Act, we expect that the national securities exchanges' independence standards for compensation committees will incorporate the SEC's suggested factors and will be similar to the independence standards for audit committees.

<sup>4</sup> The SEC's final rules do not require the national securities exchanges to apply these requirements to directors who oversee executive compensation on behalf of the board in the absence of a compensation committee. See the definition of "compensation committee" in note 2 above.

**Applicability.** The new listing standards will apply to all issuers with listed equity securities. The new listing standards requirements for compensation committee member independence, however, will not apply to the following issuers:

- controlled companies;<sup>5</sup>
- smaller reporting companies;<sup>6</sup>
- limited partnerships;
- companies in bankruptcy proceedings;
- open-end management investment companies registered under the Investment Company Act of 1940; and
- foreign private issuers that disclose in their annual report the reasons why they do not have an independent compensation committee.

Controlled companies and smaller reporting companies will also be exempt from the compensation committee listing standards governing (i) the compensation committee's authority to retain compensation advisers and (ii) compensation adviser independence. The SEC's final rules authorize the national securities exchanges to exempt, subject to SEC approval, other classes of issuers from their compensation committee listing standards, taking into consideration the size of the issuer and any other relevant factors.

**Timeline for Implementation.** The new rules will take effect July 27, 2012, which is 30 days after their publication in the Federal Register. No later than September 25, 2012, the national securities exchanges will need to propose listing standards, which will be subject to further public comment. The SEC will then need to approve the new listing standards by June 27, 2013.

### **Disclosure of Compensation Consultants' Conflicts of Interest**

Item 407(e)(3) of Regulation S-K currently requires all issuers subject to the federal proxy rules, including controlled companies, nonlisted issuers and smaller reporting companies, to make certain disclosures in their proxy statements or information statements for annual meetings (or special meetings in lieu of annual meetings) at which directors are elected, with respect to any compensation consultant<sup>7</sup> identified as having played a role "in determining or recommending the amount or form of executive and director compensation." Specifically, issuers are required to:

- identify the compensation consultant;
- state whether such consultant was engaged directly by the compensation committee or by another person;

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<sup>5</sup> A "controlled company" means a listed issuer of which more than 50 percent of the voting power for the election of directors is held by an individual, a group or another company.

<sup>6</sup> A "smaller reporting company" is generally an issuer with a public float of less than \$75 million.

<sup>7</sup> The disclosure is required only for compensation consultants, not legal counsel or other advisers to the compensation committee.

- describe the nature and scope of the consultant's assignment and the material elements of any instructions given to the consultant under the engagement; and
- disclose the aggregate fees paid to a consultant for advice or recommendations on the amount or form of executive and director compensation and the aggregate fees for additional services if the adviser provided both and the fees for the additional services were greater than \$120,000 during the fiscal year.

As required by the Dodd-Frank Act, the SEC's final rules expand the disclosure required under Item 407(e)(3) of Regulation S-K. Under new Item 407(e)(3)(iv) of Regulation S-K, issuers must disclose whether the work of any compensation consultant engaged by the compensation committee or management has raised any actual conflict of interest.<sup>8</sup> If so, the issuer must provide a description of the nature of the conflict and how it is being addressed. For purposes of whether a conflict of interest exists, issuers are directed to consider the six factors listed above that a compensation committee must consider before engaging a compensation adviser. The SEC retained the current disclosure exemption in Item 407(e)(3) for consulting services involving only broad-based, nondiscriminatory plans and the provision of noncustomized survey data.

Issuers subject to the federal proxy rules are required to comply with new Item 407(e)(3)(iv) in any proxy statements or information statements for annual meetings (or special meetings in lieu of annual meetings) held on or after January 1, 2013, at which directors are elected.

### **Observations and Next Steps**

Given the SEC's current rules and the current listing standards of the national securities exchanges, the SEC's rules and forthcoming listing standards should not have a dramatic impact on issuers.<sup>9</sup> Moreover, while the SEC's rules provide a roadmap for issuers of what to expect from the new listing standards, the ultimate impact on issuers will not be known until the national securities exchanges promulgate and adopt their new listing standards. With this in mind, there is little that issuers can do at this time to address the still-to-come listing standards. Once the new listing standards are adopted, however, issuers should:

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<sup>8</sup> The SEC's adopting release specifies that the amendments to Item 407(e)(3) of Regulation S-K require the disclosure of only actual conflicts of interest; no disclosure is required with respect to potential conflicts of interest or an appearance of a conflict of interest.

<sup>9</sup> For example:

- the current NYSE listing standards require that compensation committees be composed entirely of independent directors;
- while the current NASDAQ listing standards do not require NASDAQ-listed issuers to have a compensation committee, executive compensation decisions must be made by independent directors;
- compensation committees are generally composed of directors who satisfy other independence standards, such as those for "non-employee directors" under Exchange Act Rule 16b-3 and those for "outside directors" under Internal Revenue Code Section 162(m);
- the current NYSE listing standards specify that, if a compensation consultant is to assist the compensation committee in director or executive compensation matters, the committee's charter should provide that the committee has the sole authority to retain and terminate the consulting firm, including sole authority to approve the firm's fees and other retention terms; and
- Item 407(e)(3) of Regulation S-K currently requires significant disclosures regarding the role played by a compensation consultant in the setting of executive and director compensation.

- review the independence of the members of their compensation committees under the new independence standards; and
- review and, if needed, update their compensation committee charters and D&O questionnaires.

Since the expanded disclosure required under new Item 407(e)(3)(iv) of Regulation S-K will be effective for the 2013 proxy season, issuers will need to conduct an analysis of whether the work of any compensation consultant engaged by the compensation committee or management has raised any actual conflicts of interest. This analysis will require issuers to implement disclosure controls and procedures (or refine existing disclosure controls and procedures) to collect and analyze the information needed to make this determination.

## **Contacts**

**W. Lake Taylor, Jr.**  
tlake@hunton.com

**J. Steven Patterson**  
spatterson@hunton.com

**Olga Khvatskaya**  
okhvatskaya@hunton.com

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